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# Incorporation Planning in Texas

George A. Pelletier

Frederick W. Marsh Jr.

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# INCORPORATION PLANNING IN TEXAS

*by*

*George A. Pelletier\**  
*Frederick W. Marsh, Jr.\*\**

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\* B.B.A., J.D., Notre Dame University; LL.M., Harvard University. Associate Professor of Law, Southern Methodist University.

\*\* B.S., M.B.A., Louisiana Polytechnic Institute; J.D., Southern Methodist University. Attorney at Law, Dallas, Texas.

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INCORPORATION planning is the process of ascertaining the facts regarding a proposed business venture and then transforming those facts into a sound and workable plan of incorporation. The client who comes to the attorney wishing to incorporate has seldom developed any ideas as to the form or structure the business should have, as he is generally much more concerned with the attraction of capital and development of operating goals. It is the role of the attorney to take these goals and the available resources and mold the corporation to fit the particular needs of his client. One aspect of this task that is perhaps the most difficult is the apportionment of ownership, risk and control among the participants. In the overall planning of the corporation the lawyer has a myriad of tools at his disposal, including the articles of incorporation, bylaws, minutes of the organizational meeting, stock certificates, shareholder agreements, buy-sell agreements, and employment agreements. All too often lawyers, in drafting these instruments, rely upon form-book "boiler plate" and fail to individually tailor them to meet the needs of their clients. But corporations, like individuals, have differing needs and desires. It is the purpose of this Article to present the various aspects of Texas corporation laws which should be considered by the attorney when incorporating a business in Texas.

#### I. DISTINCTIONS BETWEEN ARTICLES OF INCORPORATION AND BYLAWS

The articles of incorporation (often referred to as the charter) and the bylaws of the corporation constitute the two major corporate documents. Great diversity of opinion exists regarding what items should be included within which document and the amount of detail to be included within each.<sup>1</sup> Thus arises the importance in proper incorporation planning, for the draftsman to understand the major distinctions between the articles of incorporation and the bylaws.

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<sup>1</sup> The content of the charter is now a matter largely codified by statute; however, this is not true of the bylaws. See TEX. BUS. CORP. ACT ANN. art. 3.02, as amended, (Supp. 1968) (charter), and *id.* art. 2.23 (1956) (bylaws).

A corporate charter is often described as a threefold contract (a) between the state and the corporation, (b) between the corporation and its shareholders, and (c) among the shareholders *inter se*.<sup>2</sup> Accordingly, charter provisions are binding upon all inter- and intra-corporate matters. Because of the tripartite nature of this relationship, the articles of incorporation can be said to consist of not only the specific clauses contained therein but also the laws applicable thereto.<sup>3</sup> There is constitutional and statutory authority in every state which must be read into the charter of a modern corporation, thus qualifying the language of the document.<sup>4</sup> With respect to matters neither superimposed by the federal or state constitutions nor by state statutes, the charter is considered the fundamental and organic law of the corporation.<sup>5</sup> Although the United States Supreme Court very early established that the charter of a corporation is a contract entitled to the protection afforded by article I, section 10 of the Constitution, which prohibits the states from passing any law impairing the obligations of contracts, this guaranty has in later years been held not to prevent subsequent changes in corporate laws from having binding effect upon existing corporations.<sup>6</sup>

A bylaw, on the other hand, may be defined as a rule for governing the internal affairs of the corporation, arising from an agreement or contract between the corporation and its members to conduct the corporate business in a particular manner.<sup>7</sup> Its function is to prescribe the rights and duties of the shareholders with reference to the internal government of the corporation, management of corporate affairs, and the rights and duties of officers, employees, agents, and other members of the corporation *inter se*.<sup>8</sup> Thus, the bylaws are not in the nature of legislative enactments; they are, rather, regulations of the corporation regarding the control and management of its affairs, binding only upon intra-corporate matters, and materially differing from the charter.<sup>9</sup> If not in contravention of any constitutional, statutory, or charter provision, the bylaws are a contract between the corporation and its members and among the members them-

<sup>2</sup> See *Personal Indus. Bankers v. Citizens Budget Co.*, 80 F.2d 327 (6th Cir. 1935); *Western Foundry Co. v. Wicker*, 403 Ill. 260, 85 N.E.2d 722 (1949); *Opdyke v. Security Sav. & Loan Co.*, 157 Ohio 121, 105 N.E.2d 9 (1952).

<sup>3</sup> See *Oregon Ry. & Navigation Co. v. Oregonian Ry.*, 130 U.S. 1 (1888); *Arkansas Stave Co. v. State*, 94 Ark. 27, 125 S.W. 1001 (1910); *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N.E.2d 502 (1940), *aff'd*, 312 U.S. 659 (1941); *Sanderson v. Salmon River Canal Co.*, 45 Idaho 244, 263 P. 32 (1927); *Westport Stone Co. v. Thomas*, 175 Ind. 319, 94 N.E. 406 (1911); *State ex rel. Swanson v. Perham*, 30 Wash. 2d 368, 191 P.2d 689 (1948); *Milwaukee Sanitarium v. Swift*, 238 Wis. 628, 300 N.W. 760 (1941).

<sup>4</sup> *Shaw v. Lone Star Bldg. & Loan Ass'n*, 123 Tex. 373, 71 S.W.2d 863 (1934). The corollary is that the powers, privileges, and immunities specified in the legislative act authorizing organization of a corporation cannot be added to or enlarged by the charter or other instruments. *A.B. Frank Co. v. Latham*, 145 Tex. 30, 193 S.W.2d 671 (1946).

<sup>5</sup> See, e.g., *Trico Elec. Co-op. v. Ralston*, 67 Ariz. 358, 196 P.2d 470 (1948).

<sup>6</sup> *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819). See generally 2 B. SCHWARTZ, A COMMENTARY ON THE CONSTITUTION OF THE UNITED STATES—THE RIGHTS OF PROPERTY 301-04 (1965), where the author states that the practical impact of the *Dartmouth* case has been all but eliminated.

<sup>7</sup> *St. Regis Candies v. Hovas*, 8 S.W.2d 574 (Tex. Civ. App. 1928).

<sup>8</sup> See, e.g., *Wells v. Black*, 117 Cal. 157, 48 P. 1090 (1897); *Voorheis v. Walker*, 227 Mich. 291, 198 N.W. 994 (1924); *Diedrick v. Helm*, 217 Minn. 483, 14 N.W.2d 913 (1944); *Colcord v. Granzow*, 137 Okla. 194, 278 P. 654 (1928).

<sup>9</sup> See *Dempster Mfg. Co. v. Downs*, 126 Iowa 80, 101 N.W. 735 (1904).

selves, but not necessarily between the state and the corporation, as is true of the charter.<sup>10</sup>

In Texas the charter and bylaws also differ regarding the manner in which the documents are handled by the corporation pursuant to state law. The articles of incorporation are prepared for filing with the Secretary of State, and the document does not become operative until accepted by the Secretary.<sup>11</sup> Once filed and accepted, the articles of incorporation become a matter of public record open for inspection. When the corporation has begun business, the articles may be changed by amendment *only* upon the approval of the holders of at least *two-thirds* of the outstanding shares entitled to vote thereon<sup>12</sup> and the subsequent filing of the amended articles with the Secretary of State.<sup>13</sup> The bylaws, however, with one exception, are neither subject to administrative scrutiny nor a matter of public record, and are usually more easily amended by a majority vote of the shareholders, or by the directors if they have been delegated this power.<sup>14</sup>

The draftsman should realize that the corporate charter is more akin to a legislative enactment, more public in nature, and less subject to change than the corporate bylaws. With this in mind, the draftsman must strive to keep his client within the bounds of the applicable law by assisting him in determining whether a particular provision should be placed in the charter, the bylaws, or some other corporate instrument, or whether the provision should be omitted from the corporate instruments altogether.

## II. DRAFTING THE ARTICLES OF INCORPORATION

### A. Contents Generally Required by Statute

Incorporation under the laws of Texas is a relatively simple procedure available to anyone having the money to pay the \$100 filing fee and the attorney's fees. A corporation may not commence business, however, until it has received for the issuance of its shares at least \$1,000 in money paid, labor done, or property actually received. Three or more natural persons, of whom two are citizens of Texas and all are twenty-one years of age or more, may incorporate a business by filing articles of incorporation with the Secretary of State.<sup>15</sup> Such articles are required to state only (1) the name of the corporation, (2) the period of its duration, (3) the purpose of its organization, (4) the aggregate number of shares authorized and their par value, if any, (5) that the corporation will not commence business until it has received for the issuance of its shares at least \$1,000 in money paid, labor done, or property actually received, (6) the name of the initial registered agent and the address of the initial registered office,

<sup>10</sup> See, e.g., *Knight v. Shutz*, 141 Ohio 267, 47 N.E.2d 886 (1943); *Bechtold v. Coleman Realty Co.*, 367 Pa. 208, 79 A.2d 661 (1951).

<sup>11</sup> See TEX. BUS. CORP. ACT ANN. arts. 3.03, 3.04 (1956).

<sup>12</sup> *Id.* art. 4.02A(3).

<sup>13</sup> *Id.* art. 4.05.

<sup>14</sup> See *Id.* art. 2.23. Appropriate parts of the bylaws may, however, be filed for record under *id.* art. 2.19F when there are restrictions on transferability of shares, or the shares are subject to a buy-sell agreement.

<sup>15</sup> TEX. BUS. CORP. ACT ANN. art. 3.01 (1956). *Id.* art. 1.02A(3) defines the articles of incorporation as "the original or restated Articles of incorporation and all amendments thereto."

(7) the number of the initial directors and their names and addresses, and (8) the names and addresses of the incorporators, plus a recitation that all are twenty-one or over and that two are citizens of Texas.<sup>16</sup> Although the Act clearly prescribes the mandatory contents of the charter and these formal requirements appear to be simple, approximately twenty per cent of the 12,000 charters filed annually with the Secretary of State's office are returned for corrections.<sup>17</sup> Some of these mistakes are as obvious as the omission of a notary seal, failure of the incorporators to sign both the original and duplicate articles, or referring to the corporation by two different names in the articles (e.g., as "Inc." and also as "Incorporated"). Many of these errors can be easily avoided by the attorney if he will just recheck the instrument before mailing it to the Secretary. The following comments are designed to give a more detailed discussion of each of the mandatory provisions of the articles of incorporation.

*Name.* The first item required by article 3.02A of the Texas Business Corporation Act (hereafter referred to as the TBCA) to be stated within the articles of incorporation is the corporate name. The use of just any name is not permitted. The chosen corporate name must meet three specific requirements of article 2.05 of the TBCA. First, the name must contain the word "corporation," "company," "incorporated," or an abbreviation thereof.<sup>18</sup> Secondly, the name must not contain any word or phrase indicating or implying that the corporation is organized for any purpose other than the purpose or purposes stated in its articles of incorporation. And finally, the name must not be the same as, or deceptively similar to, the name of any existing Texas corporation or foreign corporation authorized to do business in Texas, or a name which has been appropriately reserved or registered by another corporation under articles 2.06 or 2.07 of the TBCA.

After the client and his attorney have chosen a particular corporate name, the attorney should clear the name with the Secretary of State's office before filing the articles of incorporation. The attorney may do this by telephoning the Secretary of State's office and filing the articles of incorporation soon thereafter, or by making application to the Secretary of State for a reservation of the corporate name. If the latter approach is chosen and if the Secretary determines that the name is not the same as, or deceptively similar to, one which is already being used or which is under reservation or registration, he will reserve the use of the requested corporate name for a period of 120 days, computed from the date the Secretary issues the certificate of reservation.<sup>19</sup> Thus, by reserving the name, the attorney has 120 days in which to file the articles of incorporation with the assurance

<sup>16</sup> TEX. BUS. CORP. ACT ANN. art. 3.02, *as amended*, (Supp. 1968).

<sup>17</sup> Lecture by Ivon Lee, Legal Counsel, Office of the Secretary of State, presented at Southern Methodist University School of Law, Mar. 2, 1968.

<sup>18</sup> As an accommodation to the British Commonwealth countries, if the firm is a foreign corporation, the name may contain the word "limited" or "Ltd." TEX. BUS. CORP. ACT ANN. art. 8.03 (1956).

<sup>19</sup> *Id.* art. 2.06. The fee for this service is \$10.00. *Id.* art. 10.01A(8), *as amended*, (Supp. 1969) (effective Sept. 1, 1969).

that the articles will not be rejected because of an invalid corporate name. As a practical matter, the attorney should at least clear the corporate name with the Secretary of State's office by telephone before filing the articles of incorporation.

In determining the availability of a corporate name, the Secretary of State simply disregards the words "corporation," "company," "incorporated," or the abbreviations thereof, and simple article adjectives such as "the." The Secretary is interested only in the substance of the name itself. Thus, if the client wants to use "ABC, Incorporated," and there is currently in existence a company called "The ABC Company," the desired name is unavailable. On the other hand, if the client adds a number of words to the particular name, he may be granted permission to use it. For example, if "ABC Company" already exists, and the client wants to use the name "ABC Enterprises, Inc." or "ABC Industries" or "ABC Development Company," the desired name will be available. There are instances in which a desired name, although not identical or deceptively similar, will be so close to the name of an existing corporation that a great likelihood of infringement exists. In these circumstances, the Secretary of State may require a letter of consent from the existing corporation before clearing the desired name.<sup>20</sup> A group of related corporations will frequently have similar names which the Secretary of State will permit upon the filing of appropriate letters of consent.

As a final suggestion, the attorney should use the exact same style of the approved corporate name throughout the articles of incorporation and any other corporate documents filed on behalf of the corporation; otherwise, the articles or subsequent documents may be rejected by the Secretary of State.

*Duration.* The next mandatory item to be placed in the articles of incorporation is the duration of corporate existence. Article 3.02A(2) of the TBCA permits perpetual duration of a corporation and, except in most unusual circumstances, the duration of the corporation should be stated as perpetual. A few attorneys continue to file articles of incorporation specifying a fifty-year life, a holdover from the former law limiting the maximum term of corporate existence to fifty years.<sup>21</sup> Such a limitation may result in the inadvertent expiration of the client's corporation. Of course, there is nothing illegal in specifying a limited duration for the corporation, but this limitation should be carefully studied by the attorney before using it in the articles of incorporation. Almost all corporate charters filed in Texas currently provide for perpetual duration.<sup>22</sup>

*Purpose.* Perhaps no other mandatory item of the articles of incorporation is more difficult to draft properly than the purpose clause. Since most

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<sup>20</sup> See *id.* art. 2.05A(3) (1956).

<sup>21</sup> Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, some 989 (or 98.9%) provided that the corporate duration was to be perpetual, whereas only 11 (or 1.1%) contained a 50-year duration clause.

<sup>22</sup> *Id.*

clients, practically speaking, prefer corporate documents that "really say something," the attorney is often faced with the problem of determining whether the purpose clause should be general and brief, or specific and detailed. There is no unity of opinion about drafting this clause, and quite valid reasons are advanced for a simple statement of broad purposes,<sup>23</sup> a detailed enumeration of explicit purposes,<sup>24</sup> or a compromise between the two.<sup>25</sup>

Under pre-TBCA law a corporation could not be organized for multiple purposes.<sup>26</sup> The enactment of the TBCA in 1955 introduced the multiple-purpose approach by permitting a corporation to be organized "for any lawful purpose or purposes" provided such purpose or purposes were "fully stated in the articles of incorporation."<sup>27</sup> Inspired by this statutory revolution, many attorneys began to list page after page of corporate purposes. However, this tendency has changed with the realization that the more one lists, the more he restricts. Today, the trend in Texas is toward a short purpose clause consisting of perhaps no more than a single paragraph.<sup>28</sup> Even though Texas has abandoned its former single-purpose position, a careful reading of all the provisions of TBCA article 2.01 reveals that there are a number of purposes for which a corporation cannot be organized under the TBCA; these situations are controlled instead by special statutes.<sup>29</sup>

While brief purpose clauses are permissible, Texas has not yet become as liberal as some other states. For example, under a recent 1967 amendment, Delaware permits a purpose clause stating that the purpose of the corporation is "to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware."<sup>30</sup>

<sup>23</sup> The American Bar Association suggests that good practice entails a statement of corporate purposes in simple terms, apparently on the theory that such terms allow broad interpretation. Draftsmen favoring the brief, general statement believe that the generality of the broad purpose clause is hindered by the cataloguing of detailed explicit statements of purpose. K. PANTZER & R. DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BYLAWS* 35 (1968). Professor Ballantine gives three reasons why a broad purpose clause might be desirable: "1. to give a wide discretion and authority to the directors as to the scope of the business, 2. to assure the validity of contracts against a plea of *ultra vires* [of less utility today], 3. to protect directors against possible liability for exceeding their authority." H. BALLANTINE, *CORPORATIONS* 222 (1946).

<sup>24</sup> Professor Lattin argues that the better practice in drafting the purpose clause is to include "only those purposes which are presently intended to be within the area of the particular business and those *which may reasonably be indicated in the foreseeable future*." N. LATTIN, *CORPORATIONS* 179 (1959) (emphasis added).

<sup>25</sup> A compromise position is taken by Professor Henn when he notes that the purpose clause "should express the nature and scope of the business and risk as agreed upon among the shareholders. Therefore, the . . . clause . . . should be so drafted as to be definite enough to curb excursions into unauthorized ventures and yet sufficiently general to permit reasonable operations and expansion without the necessity of future amendment of the articles of incorporation." H. HENN, *CORPORATIONS* 159-60 (1961).

<sup>26</sup> See TEX. REV. CIV. STAT. ANN. art. 1302 (individual sections of this article were enacted at different times but the entire article was repealed by the Texas Business Corporation Act).

<sup>27</sup> TEX. BUS. CORP. ACT ANN. art. 2.01A (1956).

<sup>28</sup> For example, statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, some 514 (or 51.4%) contained a one-paragraph purpose clause, some 114 (or 11.4%) contained a two-paragraph purpose clause, some 249 (or 24.9%) contained a five-paragraph purpose clause, and some 59 (or 5.9%) contained a ten-paragraph purpose clause.

<sup>29</sup> Examples of businesses which may not be organized under the Texas Business Corporation Act include non-profit institutions, banks, trust companies, building and loan associations, insurance companies, railroad companies, cemetery companies, cooperatives, labor unions, abstract and title insurance companies. See TEX. BUS. CORP. ACT ANN. art. 2.01B(4) (1956).

<sup>30</sup> DEL. CODE ANN. tit. 8, § 102(a)(3), *as amended*, (1967). One commentator is highly im-



This would not be a fully stated purpose in Texas. However, one recommended clause for a broad, fully stated purpose under the TBCA, and one acceptable to the Secretary of State's office, is: "To buy, sell, lease, and deal in services, personal property, and real property subject to Part Four of the Texas Miscellaneous Corporation Laws Act."<sup>31</sup> This concise phrase includes most conceivable corporate activities, such as manufacturing, franchising, purchasing stock in other corporations, and, in addition, avoids the pitfalls of overstatement which usually result in the inclusion of purposes prohibited under the TBCA.

*Authorized Shares.* The concept of share authorization involves only one segment in planning the capital structure of the corporation. The proper approach of capital structure planning should be to consider the task in broad perspective—planning the entire financial goals of the business organization, including consideration of the main objectives of the division of profit and control. In attaining these objectives, the draftsman may utilize one or more classes of stock, provide for multiple types of debt, issue preferred stock in series, and have prescribed stockholders participating either on a half-equity (stock) and half-debt (bonds) basis or on a no-debt basis. These and many more alternatives are viable under the flexible language of the TBCA since there are few significant statutory limitations regarding corporate capitalization in the Act.

The articles of incorporation must state the aggregate number of shares authorized, their classification and par value, if any, and their preferences, limitations, and other relative rights, if applicable.<sup>32</sup> Corporate shares can exist *only* pursuant to the authorization of the corporation, and this authorization must be expressed in the articles of incorporation.<sup>33</sup> If there is more than one class of stock, the provisions relative thereto "must be repeated in full or in summary form on the stock certificates, but their *authority* comes *only* from their statement in the articles."<sup>34</sup> However, corporate debt, regardless of what form it takes, does not have to be authorized in the articles.

The TBCA contains no limitation on the number of shares that may be authorized in the articles of incorporation.<sup>35</sup> Yet corporate draftsmen should be aware of the fact that the office of the Secretary of State requires

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pressed with the new Delaware provision, for, as he sees it, "the certificate need no longer recite in tedious detail all conceivable types of business which a corporation might wish to undertake at some future date . . . [and] the corporation, by including an 'all-purpose' statement, enables its directors to pursue some new business activity without having to secure an amendment of the certificate or otherwise to determine that the new business is within the corporate powers." E. FOLK, *THE NEW DELAWARE CORPORATION LAW* 2 (1967).

<sup>31</sup> Lecture by Ivon Lee, Legal Counsel, Office of the Secretary of State, presented at Southern Methodist University School of Law, Mar. 2, 1968. See generally Lake, *Corporate Name and Purpose Clauses Under Texas Corporation Act*, 23 TEX. B.J. 827 (1960).

<sup>32</sup> TEX. BUS. CORP. ACT ANN. art. 3.02A(4), as amended, (Supp. 1968).

<sup>33</sup> *Id.* These provisions relating to the capital stock of the corporation may be repeated in the bylaws.

<sup>34</sup> Campbell, *The Drafting of Articles of Incorporation and Bylaws Under the Texas Business Corporation Act*, *Proceedings, Texas Business Corporation Act Institute*, 3A TEX. REV. CIV. STAT. ANN. 576, 582 (1956) (emphasis added). See TEX. BUS. CORP. ACT ANN. art. 2.19B (1956).

<sup>35</sup> The TBCA simply authorizes the corporation to issue the number of shares expressed in the articles. TEX. BUS. CORP. ACT ANN. art. 2.12A (1956).

that if par stock is utilized, the aggregate value of the stock *authorized* by the articles of incorporation must be at least \$1,000 (*i.e.*, the number of authorized shares x par value = \$1,000 or more).<sup>36</sup> This formal requirement can be met by simply authorizing a sufficient number of shares so that the par value of the authorized shares equals the necessary \$1,000, regardless of whether the corporation intends to issue all of the authorized shares. For example, the office of the Secretary of State would not approve a charter which authorized 1,000 shares of 10¢ par value stock even if the stock were sold at \$10 per share (1,000 authorized shares x \$.10 = \$100). To secure the Secretary's approval, however, all the draftsman need do is to increase the number of authorized shares to 10,000, which would then provide the corporation with a total authorized capital of \$1,000 (10,000 authorized shares x \$.10 par value = \$1,000). The only disadvantage to this procedure may lie in the fact that the corporation will have authorized but unissued shares which subsequently can be issued at will by the board of directors, subject to possible preemptive rights of the existing shareholders.

Many attorneys consider it advisable to *authorize* somewhat more shares than are intended to be *issued* originally. This practice of having authorized but unissued shares eliminates the burdensome necessity of amending the articles of incorporation to provide additional shares when needed (*i.e.*, for new shareholders or for stock splits). However, since some states impose a tax on *authorized* rather than *issued* shares, the practice of having an excess of authorized shares could impose an unnecessary expense on the Texas corporation when qualifying to do business in these states.

*Consideration.* The issuance of shares raises the question of the nature and sufficiency of the consideration for which the shares may be issued. The problem of determining what constitutes "consideration" in the Texas corporate context is not strictly one of draftsmanship, but rather of substantive law. Yet some understanding of the term is a requisite to proper corporate planning and drafting of corporate documents. Generally, the problem of consideration involves two basic questions: (1) What constitutes sufficient consideration? (2) What is the value of the consideration received?

Regarding the first question of sufficient consideration, article 2.16 of the TBCA, which parallels article 12, section 6 of the Texas Constitution, provides that "the consideration paid for the issuance of shares shall consist of money *paid*, labor *done* or property *actually received*,"<sup>37</sup> and "[n]either promissory notes nor the promise of future services shall constitute payment or part payment for shares of a corporation."<sup>38</sup> The Texas

<sup>36</sup> The authority for this requirement is derived from *id.* art. 4.12E which provides that the stated capital may not be reduced below \$1,000.

<sup>37</sup> TEX. BUS. CORP. ACT ANN. art. 2.16A (1956) (emphasis added).

<sup>38</sup> *Id.* art. 2.16B. This requirement, which is similar to that found in most state corporate laws, comes from the TEX. CONST. art. 12, § 6. The constitutional provision was said to be a guaranty against "watered stock," that is, stock which purports to be paid for in full, but which in fact has not been paid for. It was originally added to the Constitution in response to the Credit Mobilier

courts have construed the provisions of article 2.16A of the TBCA literally. Thus, "property" means property capable of being readily applied to the debts of the corporation.<sup>39</sup> Whereas an unpatented formula is not "property,"<sup>40</sup> a patent is.<sup>41</sup> By careful planning, property can probably be created by transforming ideas or processes, which are not good consideration under Texas law, into written manuals or programs. Also, a trade name or application pending on a patent or trademark would constitute good consideration. In addition, "property" includes contract rights transferred to the corporation,<sup>42</sup> as well as an oil and gas lease in a partially proven territory.<sup>43</sup> Further, before shares can be issued the full amount of consideration must have been paid to the corporation.<sup>44</sup> Once this is done the shareholder is under no further obligation to the corporation or its creditors with respect to such shares.<sup>45</sup> As a practical matter it is advisable to document the receipt of consideration by a special receipt reciting that it is for shares, or, as is more commonly done, by appropriate recitation in the minutes.

In resolving the second question of the value of the consideration received there are two basic tests. The "true value" test requires that the value of the consideration received equal the indicated value of the stock issued therefor. This test is uncompromisingly harsh in application because it is often very difficult to value consideration that is received in forms other than cash. Furthermore, the test really offers no assistance to those persons in the corporation who have the responsibility of valuing such consideration. On the other hand, the "good faith" test allows the board of directors to value the consideration received, for example, in the form of property, and that value will be conclusive in the absence of fraud. Texas follows the "good faith" test; thus valuation of consideration by the proper person having such responsibility is conclusive in the absence of fraud.<sup>46</sup>

Substantial authority exists in Texas to the effect that TBCA article 2.16C is likewise subject to literal interpretations; thus, a declaration by the board of directors regarding the valuation of consideration is presumed valid in the absence of fraud.<sup>47</sup> In fact, the courts have not shown

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scandal of 1872. 2 TEX. CONST. ANN. 712 (1955). See generally *Champion v. Commissioner*, 303 F.2d 887 (5th Cir. 1962).

Although, broadly speaking, a promissory note is "property," the Texas supreme court very early set forth the rationale as to why such a note was not valid "consideration" for the issuance of shares. The integrity of a corporation and the interests of the public demand that the assets of the corporation consist of something more than its stockholders' debts; thus, the corporation cannot accept a subscriber's note in payment for his stock. *Washer v. Smyer*, 109 Tex. 398, 211 S.W. 985 (1919). See also *Langdeau v. Dick*, 356 S.W.2d 945 (Tex. Civ. App. 1962), *error ref. n.r.e.* (holding that notes secured by a deed of trust on real property covering the purchase of debenture bonds issued by an insurance company were "property").

<sup>39</sup> *Woodson v. McAllister*, 119 F.2d 924 (5th Cir.), *appeal dismissed per stipulation*, 314 U.S. 703 (1941); *Washer v. Smyer*, 109 Tex. 398, 211 S.W. 985 (1919).

<sup>40</sup> *O'Bear-Nester Glass Co. v. Anti-Explo Co.*, 101 Tex. 431, 108 S.W. 967 (1908).

<sup>41</sup> *Atlas Trailers & Water Mufflers, Inc. v. McCallum*, 118 Tex. 173, 12 S.W.2d 957 (1929).

<sup>42</sup> *General Bonding & Cas. Ins. Co. v. Moseley*, 110 Tex. 529, 222 S.W. 961 (1920).

<sup>43</sup> *McAllister v. Eclipse Oil Co.*, 128 Tex. 449, 98 S.W.2d 171 (1936).

<sup>44</sup> TEX. BUS. CORP. ACT ANN. art. 2.16A (1956).

<sup>45</sup> *Id.* art. 2.21A.

<sup>46</sup> *Id.* art. 2.16C provides: "In the absence of fraud in the transaction, the judgment of the board of directors or the shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive."

<sup>47</sup> *Sandor Petroleum Corp. v. Williams*, 321 S.W.2d 614 (Tex. Civ. App. 1959), *error ref. n.r.e.*;

any great willingness to question this presumption, and will do so only where there is a clear abuse of discretion by the board of directors.<sup>48</sup> However, in *United Steel Industries, Inc. v. Manhart*<sup>49</sup> the court failed to give presumptive effect to the board of directors' valuation of the consideration. This result was at least unusual, if not unwarranted, because the board had given written approval of the issuance of stock for "services." Admittedly, the apparent arrangement was to issue stock for services performed, or to be performed, during the first year of corporate existence. However, at the time the stock was issued, some, but not all, of the agreed services *had been performed* on behalf of the corporation, and at the trial there was substantial disagreement as to the nature, adequacy and valuation of the performed services as consideration. Although TBCA article 2.16C speaks of the conclusiveness of the directors' judgment regarding the value of consideration received, the court undauntedly stated: "The judgment of the board of directors 'as to the value of consideration received for shares' is conclusive, but such does not authorize the board to issue shares contrary to the Constitution, for services to be performed in the future . . . or for property not received . . .'"<sup>50</sup> Although in *Manhart* part of one shareholder's stock had been issued for *past* services, the court affirmed the cancellation of *all* of his stock, refusing to apportion between stock issued for past services and stock issued for future services. Thus, the meaning and effect of the rather clear wording of article 2.16C has been somewhat clouded by the *Manhart* decision. The holding gives too restrictive an interpretation of the "good faith" test, and perhaps spells future trouble in this area of corporate law.

The general problem of the value of consideration can, to some extent, be alleviated by careful planning. If the situation is desperate, a corporation could always make a salary advance to a prospective shareholder-employee or place a value upon his pre-incorporation services, which amount could then be used as consideration to purchase stock, although this would probably constitute taxable income to the shareholder-employee. Another possibility would be a loan from the other shareholders to the shareholder lacking adequate funds, or third party secured notes would be appropriate consideration for stock even though the shareholder's own unsecured note would not.

If only one of the prospective shareholders intends to contribute doubtful consideration, the problem can be handled by having that shareholder contribute an additional amount of valid consideration, preferably cash. Professor Herwitz suggests that consideration for issued stock involving \$500 cash plus doubtful consideration from one shareholder and \$50,000 cash from another shareholder would be perfectly acceptable even though

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Smith v. Ideal Laundry Co., 286 S.W. 285 (Tex. Civ. App. 1926), *error dismissed*; Peden Iron & Steel Co. v. Jenkins, 203 S.W. 180 (Tex. Civ. App. 1918), *error ref.* See also Coit v. North Carolina Gold Amalgamating Co., 119 U.S. 343 (1886); Elward v. Peabody Coal Co., 9 Ill. App. 2d 234, 132 N.E.2d 549 (1956).

<sup>48</sup> See cases cited in note 47 *supra*.

<sup>49</sup> 405 S.W.2d 231 (Tex. Civ. App. 1966), *error ref. n.r.e.*

<sup>50</sup> *Id.* at 233.

both investors end up with the same amount of stock.<sup>51</sup> This procedure should only be used if there is full disclosure to, and agreement by, all the shareholders. A possible danger with this stock issuance plan is that the shareholder with the modest contribution shares equally in the control of the corporation. There is also the possibility of this shareholder forcing an early dissolution in which event he would share on an equal per share basis with the shareholder that had made the larger per share contribution. This result can, of course, be limited by either using two classes of stock, limiting voting rights, or executing a voting agreement or voting trust. The authors have some hesitancy in recommending this procedure in Texas to the full extent suggested by Professor Herwitz as a result of the *Manbart* decision which might lead a court to hold that the difference amounted to compensation for future services.

*Par Versus No-Par Stock.* The articles of incorporation must either state the par value of the authorized shares or state that they have no par.<sup>52</sup> In either case, the shares may not be issued for less than par or for less than the full stated value attached to the no-par shares.<sup>53</sup> Thus, caution should be twice exercised by the board of directors in the valuation-of-consideration process. First, the value placed on the consideration (property or service) received by the corporation for the issuance of its shares should be commensurate with the nature and utility of such property or service to the corporation. And second, the value of such property or service to the corporation should be equal to or greater than the par value of par stock or the assigned or stated value of no-par stock issued therefor; otherwise, the issued stock would be "watered" and the *subscriber* could be held liable<sup>54</sup> to the corporation or its creditors for the difference between the stock's purchase price and its par or assigned value.<sup>55</sup>

"Historically, the issuing price of shares of a company and the par value of the shares were identical."<sup>56</sup> The corporation's capital was simply the aggregate amount received as consideration for the issuance of shares, and stock issued for less than par value amounted, with rare exception, to watered stock, because there had not been adequate consideration.<sup>57</sup> The ensuing frustrated corporate financial planning led to the development in modern incorporation statutes of low-par and no-par stock, which has caused

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<sup>51</sup> See Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098 (1962).

<sup>52</sup> TEX. BUS. CORP. ACT ANN. art. 3.02A(4), as amended, (Supp. 1968).

<sup>53</sup> *Id.* art. 2.15A, B (1956). See also *id.* art. 2.16A.

<sup>54</sup> *Id.* art. 2.21A.

<sup>55</sup> In *Fulton v. Abramson*, 369 S.W.2d 815 (Tex. Civ. App. 1963), a fictitious partnership was transferred to a corporation in return for some of its shares. Later additional stock was sold to another shareholder at \$1.00 per share. Upon bankruptcy the partnership transferors, when sued by the trustee in bankruptcy of the corporation, argued that since full consideration had not been paid for the stock they held, such stock was "illegal" under the TEX. BUS. CORP. ACT ANN. art. 2.16 (1956), and thus they did not have to pay the difference between what was paid for the stock and its value at issuance. The court held that the language of art. 2.16 was not designed to shield the delinquent shareholders who were arguing that the stock issuance was illegal.

<sup>56</sup> Knauss, *Capitalization and Financing*, in PROCEEDINGS OF THE 1965 TWENTIETH ANNUAL MISSISSIPPI LAW INSTITUTE ON CORPORATE PRACTICE 58 (1965).

<sup>57</sup> See Comment, 'Watered Stock'—Shareholder's Liability to Creditors in Arizona, 8 ARIZ. L. REV. 327 (1967).

the concept of "watering" to lose much of its practical significance. If the corporation uses par value stock or low-par stock (for example, stock having a low par value of \$1 per share), the consideration received in excess of the par value is considered capital surplus<sup>58</sup> and need not be allocated to the stated capital account. Thus, if the par value of stock is \$1 per share and the corporation receives \$12 per share upon issuance thereof, \$1 per share must be allocated to CAPITAL and \$11 per share may be allocated to CAPITAL SURPLUS. On the other hand, if the stock issued has no par value at all, but only a stated or assigned value, no more than twenty-five per cent of the total consideration received by the corporation for that stock may be placed in the capital surplus account.<sup>59</sup> Using the same figures as above, if no-par stock is issued for \$12 per share, a maximum of only \$3 per share may be allocated to CAPITAL SURPLUS; the remainder, or \$9 per share, must be allocated to CAPITAL.

A plentiful amount of capital surplus is desirable because it offers a great degree of financial flexibility. It is relatively unrestricted in character and supplies the financial means for effectuating many corporate actions, such as the purchase of the corporation's own shares in certain instances,<sup>60</sup> the payment of a stock dividend,<sup>61</sup> the making of a distribution in partial liquidation,<sup>62</sup> and the absorption of operating losses after elimination of earned surplus.<sup>63</sup> Thus, the use of no-par stock rarely would appear desirable. On the contrary, the use of low-par stock is the most advantageous way of creating a greater amount of capital surplus since all consideration received above par value may be placed in the capital surplus account. But despite the inherent disadvantages in no-par stock, approximately twenty per cent of all charters filed in Texas continue to use no-par stock.<sup>64</sup>

*The Necessary \$1,000 Capital.* A corporation cannot commence business until it has received at least \$1,000 in consideration for the issuance of its shares.<sup>65</sup> Thus, it is mandatory that the articles of incorporation specifically state that the corporation will not commence business until it has received for the issuance of its shares at least \$1,000 in money, labor done, or property actually received.<sup>66</sup> However, money from the \$1,000 amount may be paid out immediately for *reasonable* expenses of incorporation, without rendering the shares not fully paid and non-assessable.<sup>67</sup> The reasonable expenses of incorporation usually means attorney's fees, but can also include other expenses the promoters incurred on behalf of the corporation prior to its formation. As to the reasonableness of such amounts, a legal fee based

<sup>58</sup> TEX. BUS. CORP. ACT ANN. art. 2.17A (1956). "'Capital surplus' means the entire surplus of a corporation other than its earned surplus and its reduction surplus." *Id.* art. 1.02A(15).

<sup>59</sup> *Id.* art. 2.17B.

<sup>60</sup> *Id.* art. 2.03D.

<sup>61</sup> *Id.* art. 2.38A(3).

<sup>62</sup> *Id.* art. 2.40.

<sup>63</sup> *Id.* art. 4.13B.

<sup>64</sup> Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, approximately 20% used no-par stock; whereas, some 53% used \$1 par value and some 13% used \$10 par value.

<sup>65</sup> TEX. BUS. CORP. ACT ANN. art. 3.01A, as amended, (Supp. 1968).

<sup>66</sup> *Id.* art. 3.02A(7) (1956).

<sup>67</sup> *Id.* art. 2.18A, as amended, (Supp. 1968).

on the minimum bar fee schedule for incorporation would certainly be reasonable, but a charge amounting to all the consideration paid would probably be considered unreasonable. If an unreasonable amount were paid out, the responsible party would be the board of directors, or whoever authorized the expenditure, although the attorney advising such a decision would probably find himself impleaded in the proceedings.

This \$1,000 capital may include both stated capital and capital surplus since the statute specifically phrases the requirement in terms of "consideration," which means whatever is paid in. Some draftsmen feel that if more than \$1,000 is being invested in the corporation, this larger amount should be declared as the necessary capital, and in this regard the Secretary of State's office has received charters requiring as much as \$50,000 or \$100,000 capital. This practice is not only unnecessary but also dangerous because those who assent to this figure may possibly be liable for the entire amount if it is not actually paid.<sup>68</sup> Furthermore, a good draftsman should anticipate that a prospective investor's withdrawal or the inability otherwise to raise the large investment capital stipulated in the articles of incorporation will subject his client to the necessity of filing a subsequent amendment in order to lower the required investment capital figure. Thus, the prevailing and preferred practice in Texas is to provide for the minimum \$1,000 initial capital in the articles of incorporation.<sup>69</sup> It is worth noting that this capital requirement bears no relation to necessary working capital which will probably be substantially more than \$1,000. If the business is launched without adequate working capital for its business needs there is possible liability for the shareholders under a theory of piercing the corporate veil.

*Registered Office and Agent.* The articles of incorporation must also set forth the name of the initial registered agent and the address of the initial registered office.<sup>70</sup> The function of the registered agent is to receive official communication from and through the Secretary of State's office and service of process if the corporation is sued.<sup>71</sup> For this reason, the registered agent must be a named individual. The agent cannot be a law firm nor can it be a corporation unless the agent-corporation has been specifically authorized, as one of its purposes in its articles of incorporation, to act as agent for other corporations (*i.e.*, one of the so-called corporation service companies).

Frequently an officer of the prospective corporation will be named in the articles as the registered agent. A more desirable practice, however, is to name the corporation's attorney as the registered agent since he is accustomed to receiving legal papers and is not likely to let them go unanswered, which might be the case with a corporate officer. Furthermore, designation of the attorney as the registered agent also maintains his ties

<sup>68</sup> See *id.* arts. 2.41A(5), 3.05A (1956).

<sup>69</sup> Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, some 963 (or 96.3%) provided for initial capital of \$1,000, 9 provided for initial capital of \$2,000, 4 provided for initial capital of \$3,000, 5 provided for initial capital of \$5,000, 11 provided for initial capital of \$10,000, and 2 provided for initial capital of \$50,000.

<sup>70</sup> TEX. BUS. CORP. ACT ANN. art. 3.02A(10) (1956); see *id.* art. 2.09.

<sup>71</sup> See *id.* art. 2.11A.

with the corporation at a minimal risk of personal liability which is not the case if he serves as a director or incorporator.

To insure proper service of process, the articles must also state the address of the registered office. The registered office need not be the corporation's principal place of business, but it must be a place where the registered agent can be found. If a corporate officer is to serve as registered agent, the registered office address would normally be that of the corporation, and if a corporate service company is used, the registered office must be the business address of that particular company. The office of the registered agent must include a building or a street address; a post office box or simply the name of a city will not be sufficient. One exception is made by the office of the Secretary of State: if the population of the registered agent's town is less than 5,000, either the name of the town without a street address is acceptable or a rural route number plus a box number is acceptable and frequently used by attorneys in certain cities to escape the city tax assessor.

*Initial Directors.* The articles of incorporation must state the number of the initial directors and their names and addresses.<sup>72</sup> Most Texas corporations are of the small, close variety and will normally have only the required minimum of *three* directors.<sup>73</sup> The initial directors are responsible for conducting the affairs of the corporation until the first annual meeting of the shareholders, or until their successors are elected and meet any qualifications prescribed by the articles or bylaws. This latter situation usually occurs immediately upon formation of the corporation.

*Incorporators.* The names, addresses, and signatures of the three incorporators must be set forth in the articles of incorporation.<sup>74</sup> Recitations to the effect that all of the incorporators are natural persons (hence no other corporations) who are each twenty-one years of age or more, and at least two of whom are "citizens" of the State of Texas, must also be set forth.<sup>75</sup> Although it is far from certain what is meant by "citizens of the State of Texas," this phrase is the mandatory statutory language, and the only specification that will be accepted by the office of the Secretary of State. For example, it is not acceptable to state that two of the incorporators are merely "residents of the State of Texas."

It is very common in Texas for attorneys to serve as initial directors or incorporators, especially in the latter capacity as these are quite frequently dummies. However, this practice is fraught with hazards, including possible liability for satisfaction of the initial capital and possible exposure under recent federal decisions greatly extending the liabilities of officers

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<sup>72</sup> *Id.* art. 3.02A(11).

<sup>73</sup> *Id.* art. 2.32A. Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, 805 (or 80.5%) made provision for 3 directors, 163 (or 16.3%) made provision for 4 directors, 20 (or 2%) made provision for 5 directors, and 4 (or 0.4%) made provision for 6 directors.

<sup>74</sup> TEX. BUS. CORP. ACT ANN. arts. 3.02A(12), 3.01A (1956).

<sup>75</sup> *Id.* art. 3.01A.



and directors in the filing of registration statements and the use of inside information.<sup>76</sup>

### B. Other Provisions Which May Be Included in the Charter

In addition to the mandatory provisions previously discussed, the articles of incorporation may contain any provision which is not inconsistent with Texas corporate law or any provision required or permitted by the TBCA to be in the bylaws.<sup>77</sup> Some of the provisions are purely optional; yet others are "optional mandatory" provisions, that is, provisions which, if not covered in the articles of incorporation, will be controlled by a specific rule of Texas law on that particular point.

*Preemptive Rights.* An example of the "optional mandatory" concept is the inclusion of a provision in the articles of incorporation limiting or denying shareholders preemptive rights in acquiring additional or treasury shares of the corporation.<sup>78</sup> Unless such rights are limited or denied in the articles of incorporation the TBCA implication is that shareholders are entitled to full preemptive rights to acquire unissued as well as treasury shares of the corporation.<sup>79</sup> Thus, it is best to specify whether preemptive rights will be allowed and, if so, to what extent, in order to make clear the intention of the incorporators and to provide for the contingency of legislative amendments. If the corporation is to become publicly held, it will likely be the desire of the prospective managers to deny preemptive rights,<sup>80</sup> whereas the opposite conclusion will often be reached if the corporation is to be closely held.<sup>81</sup> It is interesting to note that of all the charters currently filed with the Secretary of State, very few make reference to preemptive rights.<sup>82</sup> The draftsman must be aware, however, that in order to properly restrict stockholder preemptive rights, the limitation or denial must be placed on the stock certificates themselves.<sup>83</sup>

*Powers.* An important distinction which should be noted is that purposes and powers are neither legally nor functionally the same. Since the two terms are not synonymous, the corporate clauses which embody each

<sup>76</sup> See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

<sup>77</sup> TEX. BUS. CORP. ACT ANN. art. 3.02A(9) (1956).

<sup>78</sup> *Id.* art. 3.02A(8).

<sup>79</sup> *Id.* art. 2.22C, as amended, (Supp. 1968). This is a somewhat broader preemptive right than is found in most states because treasury shares are seldom included.

<sup>80</sup> Denial would allow management much greater freedom of action with future issues of corporate shares, thus virtually insuring a greater price for these issues. G. SEWARD, BASIC CORPORATE PRACTICE 47 (1966).

<sup>81</sup> The reason for this is that no shareholder in the small corporation wants to see his initial attributes of ownership (voting rights, dividend rights, percentage of stock ownership) diluted. *Id.*

<sup>82</sup> Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, only 95 (or 9.5%) denied preemptive rights while only 43 (or 4.3%) granted preemptive rights.

<sup>83</sup> TEX. BUS. CORP. ACT ANN. art. 2.22C, as amended, (Supp. 1968). For the mechanics of this requirement, see Castle, *Restrictions on Transferability of Securities*, Vol. 7, No. 3 BULLETIN OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW 7 (Tex. State Bar, Jan. 1969).

should not be the same.<sup>84</sup> The corporate powers enable the corporation to carry out or implement its purposes, but the corporate purposes do not prescribe its powers.

Article 2.02 of the TBCA contains a list of numerous general powers of the corporation.<sup>85</sup> Thus, it is not necessary to set forth in the articles of incorporation any of the corporate powers enumerated in the Act.<sup>86</sup> In addition, many powers, such as the ability to establish a corporate hierarchy and to make rules for corporate internal management, exist as necessary incidents to the corporate form of doing business, and no statement thereof in the articles or bylaws is required.<sup>87</sup> Thus, some writers advocate that the powers clause should be short and general.<sup>88</sup> Specificity should only be utilized when it is desired to deny to the corporation, or to limit its exercise of, certain powers which Texas corporations generally have or to make absolutely certain that the corporation has particular stated powers (*i.e.*, article 2.02 of the TBCA makes no mention of franchising, which might prompt an overly cautious attorney to include franchising as a power).<sup>89</sup>

On the other hand, however, other writers suggest, when dealing with potentially important corporations, the specific enumeration of the principal powers which the corporation may perhaps need in the future.<sup>90</sup> Further reasons have been advanced on behalf of the detailed powers clause: (1) clients generally want articles that "say something;" they want more than a bare skeleton of a document; (2) no objection other than redundancy can be made to the express statement of that which is already granted; (3) the charter may receive principal attention from parties in a foreign jurisdiction, such as financing institutions, who will probably know little about the home state's general corporation act but will be able to read what the corporate charter specifically authorizes; and (4) the attorney, by focusing the client's attention on different alternatives, can give the client an opportunity to reject, increase, or limit certain powers.<sup>91</sup> "The draftsman may also assist the understanding of all concerned by arranging statutory powers, which are often scattered throughout a statute, in logical and coherent form."<sup>92</sup>

In drafting the powers clause, whether short and general or detailed and specific, a stipulation to the effect that the charter's express grant of certain powers shall not be construed as a limitation on other powers should be included. It may also be desirable to provide that the powers may be

<sup>84</sup> K. PANTZER & R. DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BYLAWS* 39-40 (1968):

A practice that is almost universal in corporate draftsmanship is the mingling of purposes and powers. . . . These clauses are legally effective and will pass the scrutiny of other lawyers. They will not contribute toward a client's or third party's understanding of the legal effect of the charter or advise the client of the various possibilities of the Purpose and Powers Clause. . . . The [combined] use of these clauses is not recommended.

<sup>85</sup> *Id.* See also TEX. BUS. CORP. ACT ANN. art. 2.03 (1956).

<sup>86</sup> *Id.* art. 3.02B.

<sup>87</sup> *Id.* art. 2.02A(19).

<sup>88</sup> N. LATTIN, *CORPORATIONS* 188 (1959).

<sup>89</sup> C. ROHLICH, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES* 246 (1958).

<sup>90</sup> G. SEWARD, *BASIC CORPORATE PRACTICE* 48 (1966).

<sup>91</sup> K. PANTZER & R. DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BYLAWS* 38 (1968).

<sup>92</sup> *Id.*

exercised anywhere in the world, but this does not eliminate the necessity for qualifying to do business in other jurisdictions. In addition, the latter stipulation may limit the exercise of the powers not forbidden by the laws of the foreign jurisdiction.

*Designation and Classification of Shares.* When authorized by the articles of incorporation, a corporation may issue more than one class of shares.<sup>93</sup> If there is to be more than one class of stock, any desired designations, preferences, limitations, or relative rights concerning the particular classes must be recited in the articles.<sup>94</sup> Except for permissible variations in relative rights and preferences between series, all shares within the same class must be identical.<sup>95</sup> The division of shares into classes does not appear to be a very popular device in Texas, at least regarding new corporations.<sup>96</sup> However, this practice does not dictate its nonuse.

Where there are several investors in a business, they may have entirely different wishes as to the nature and productivity of their investment, and different classes of stock can be useful in complying with their disparate goals. For example, one group of investors may desire substantial security for their capital investment and some assurance of a minimum return on their investment. Preferred stock is one means of accomplishing that. The other investors, who receive common stock, accept a greater risk, but if the business is successful, they are the principal beneficiaries of its growth.<sup>97</sup>

Perhaps the most serious disadvantage in the use of different classes of stock is foreclosure of the use of Subchapter S of the Internal Revenue Code which allows a corporation to be taxed as a partnership, an especially valuable consideration for a new corporation that is likely to have losses in its early years. Also, classification complicates the share structure, requiring separate approval of each class of stock for many fundamental corporate changes.

*Dividends.* The board of directors may from time to time declare dividends on the corporation's outstanding shares, payable in cash, property, or its own shares.<sup>98</sup> Since dividends are not legally payable until declared by the board of directors, the question becomes one of when and to what extent the board may declare dividends and out of what corporate assets may they be paid. Generally, Texas follows an "unrestricted earned surplus" test for determining when and to what extent dividends may be declared and paid;<sup>99</sup> that is, dividends may be declared and paid in cash or property only out of the unrestricted *earned* surplus on the books of the corpora-

<sup>93</sup> TEX. BUS. CORP. ACT ANN. art. 2.12A (1956).

<sup>94</sup> *Id.*

<sup>95</sup> *Id.* art. 2.13A. Permissible variations between different series of the same class are (a) the dividend rate, (b) the price, terms, and conditions of redemption, (c) sinking fund provisions for redemption, (d) the amount payable on shares in the event of either voluntary or involuntary dissolution, and (e) terms and conditions affecting conversion rights. *Id.*

<sup>96</sup> Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, only 12 had divided the common stock into two classes, and 7 had authorized common and preferred stock.

<sup>97</sup> D. KAHN, TAX AND BUSINESS PLANNING FOR CLOSELY HELD CORPORATIONS 306 (1968). See also Herwitz, *supra* note 51.

<sup>98</sup> TEX. BUS. CORP. ACT ANN. art. 2.38A (1956).

<sup>99</sup> *Id.*

tion.<sup>100</sup> In addition, dividends may be declared and paid in the corporation's own shares out of "unrestricted surplus" of the corporation.<sup>101</sup> Thus, since "surplus" is defined as "the excess of the net assets of a corporation over its stated capital,"<sup>102</sup> a stock dividend may be payable out of not only earned surplus but also capital surplus. However, it is essential to remember that no dividend may be declared and paid in cash, property, or stock when the corporation is insolvent or when the payment thereof would render the corporation insolvent,<sup>103</sup> "insolvency" being defined in the equity sense as the "inability of a corporation to pay its debts as they become due in the usual course of its business."<sup>104</sup>

Since a special or preferred class of stock may be authorized, having one or more special rights or privileges, such stock may be given a preference as to dividends and/or liquidation.<sup>105</sup> If preferred as to dividends, the stock may be either fully cumulative, cumulative only to the extent earned, non-cumulative, and/or participating or non-participating.<sup>106</sup> If cumulative, then all preferred dividends of past years must be paid before the dividend for the current year may be paid on such stock or on the common stock. If cumulative only to the extent earned, the dividends on the preferred stock cumulate in each of the past years only to the extent that the corporation had net earnings in each of those respective years. If non-cumulative, any preferred dividend not paid in the year when due is lost forever. In this regard, it should be noted that any dividends which have "accrued" but which have not been "declared" by the board of directors may be cancelled by an amendment to the articles of incorporation,<sup>107</sup> but such an amendment must be approved by an affirmative vote of at least two-thirds of the outstanding shares entitled to vote thereon.<sup>108</sup> If the preferred stock is participating, the holder thereof is entitled to receive the preferred dividend first and then to participate (fully or to a limited extent) with the common stock in any further dividends declared and paid during the year. If non-participating, the preferred stockholder is entitled only to the preferred dividend and no more. Thus while the draftsman cannot make the test for paying dividends more liberal, he can further restrict the payment of dividends by appropriate provisions in the articles of incorporation.<sup>109</sup>

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<sup>100</sup> *Id.* art. 1.02A(13), as amended, (Supp. 1968) provides:

'Earned surplus' means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus. Earned surplus shall include also any portion of surplus allocated to earned surplus in mergers, consolidations or acquisitions of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign.

<sup>101</sup> TEX. BUS. CORP. ACT ANN. art. 2.38A(2), (3) (1956).

<sup>102</sup> *Id.* art. 1.02A(12).

<sup>103</sup> *Id.* art. 2.38A.

<sup>104</sup> *Id.* art. 1.02A(16).

<sup>105</sup> *Id.* art. 2.12B(1), (3).

<sup>106</sup> *Id.* art. 2.12B(2).

<sup>107</sup> *Id.* art. 4.01B(11).

<sup>108</sup> *Id.* art. 4.02A(3).

<sup>109</sup> *Id.* art. 2.38A.

*Voting Rights.* Normally each outstanding share, regardless of its class, is entitled to one vote on each matter voted upon at the shareholders' meetings unless such voting rights are limited or denied by the articles of incorporation.<sup>110</sup> This is another "optional mandatory" provision, because if the voting rights of any class of stock are to be restricted or denied, such restriction or denial must be set forth in the articles; otherwise, each outstanding share is entitled to voting rights. It is unclear under the TBCA whether one share may have more or less than one full vote. The Secretary of State has previously refused to approve a fractional vote per share or more than one vote per share.<sup>111</sup> It should be noted that the right to vote cannot be denied on certain matters such as mergers, consolidations, or sales of significantly all of the corporate assets.<sup>112</sup>

*Cumulative Voting.* Cumulative voting, "the privilege given a shareholder in voting on directors to multiply the number of shares he owns by the number of places to be voted on and then vote the total for one nominee or distribute the same among as many nominees as he sees fit,"<sup>113</sup> has had a varied and uncertain existence in Texas law. After the TBCA was enacted in 1955, article 2.29D was amended to provide that cumulative voting did not exist unless expressly *authorized* by the articles of incorporation. This amendment expressly saved the original provision for corporations formed prior to the effective date of the amendment, August 21, 1957. Again, in 1964, article 2.29D was amended to permit cumulative voting unless expressly *prohibited* by the articles of incorporation, but nothing was said in this amendment regarding the status of cumulative voting in corporations formed between August 21, 1957, and June 1, 1964, the effective date of the latter amendment.<sup>114</sup> Under present Texas law, therefore, the shareholder is entitled to cumulative voting unless such is expressly prohibited in the articles of incorporation; however, the validity of this statement as applied to corporations formed between August 21, 1957, and June 1, 1964, is not clear. "It is the understanding of the [State Bar] Committee that at present shareholders of a domestic corporation, *whenever incorporated*, have the right of cumulative voting unless the right is expressly denied in the articles of incorporation."<sup>115</sup> Thus, in order to provide for the contingency of additional statutory amendments, it is best for the draftsman to state in the articles of incorporation whether or not cumulative voting is desired, even though the present law provides that there is a right to cumulative voting unless prohibited by the articles.

<sup>110</sup> *Id.* art. 2.29A, as amended, (Supp. 1968). Treasury shares may not be voted directly or indirectly by the corporation. *Id.* art. 2.29B (1956).

<sup>111</sup> Lecture by Ivon Lee, Legal Counsel, Office of the Secretary of State, presented at Southern Methodist University School of Law, Mar. 2, 1968.

<sup>112</sup> See TEX. BUS. CORP. ACT ANN. arts. 5.03B, 5.10A(3) (1956).

<sup>113</sup> Lebowitz, *Cumulative Voting Under Texas Law*, Vol. 3, No. 6 BULLETIN OF THE SECTION ON CORPORATION, BANKING & BUSINESS LAW 1 (Tex. State Bar, Dec. 1964). This article presents a concise and thorough discussion of cumulative voting in Texas. See TEX. BUS. CORP. ACT ANN. art. 2.29D(1), as amended, (Supp. 1968).

<sup>114</sup> For a complete discussion of the historical development of article 2.29D of the Texas Business Corporation Act, see Lebowitz, *supra* note 113, at 1-2.

<sup>115</sup> See *Comment of Bar Committee*, 3A TEX. REV. CIV. STAT. ANN. 35 (Supp. 1968) (emphasis added).

Any corporate amendment to the articles of incorporation prohibiting the right of cumulative voting is effective only after an affirmative vote of two-thirds of the shares of each class entitled to vote on such amendment.<sup>116</sup>

*Shares in Series.* A popular fund-raising technique for large corporations is to issue shares in series. Each year for several succeeding years, a certain number of preferred shares may be issued at a given dividend rate. However, only preferred shares may be issued in series, and the authorization of these shares must be stated in the articles of incorporation.<sup>117</sup> If any of these shares are later redeemed, they will revert to the authorized-but-unissued status unless the articles of incorporation provide otherwise.<sup>118</sup>

*Redemption of Shares.* Redemption is one method by which the corporation may reacquire its own shares. Any type of stock, common or preferred, that has a preference in liquidation may be made redeemable, although liquidation preferences are more often a feature of preferred stock. *Redemption* is to be distinguished from *repurchase* in that the former type of reacquisition of shares is pursuant to an agreement. Such a procedure is governed by four important rules: (1) only shares having a liquidation preference and not just a dividend preference may be redeemed,<sup>119</sup> (2) shares may be redeemed only if authorized by the articles of incorporation,<sup>120</sup> (3) the shares must be redeemed by a resolution of the board of directors,<sup>121</sup> and (4) the redeemed shares shall be cancelled (by the procedure set forth in TBCA article 4.10B), and upon cancellation such shares shall revert to the status of authorized-but-unissued shares unless the articles of incorporation state that they shall not be reissued.<sup>122</sup>

When shares are not made redeemable, the only way a corporation can acquire them is by purchase. The permissible reasons for reacquiring the shares are (1) to eliminate fractional shares, (2) to collect or compromise indebtedness owed by or to the corporation, (3) to pay dissenting shareholders entitled to appraisal payment, and (4) to effect the purchase or redemption of its redeemable shares.<sup>123</sup> In general, the shares may be purchased to the extent that the corporation has sufficient unrestricted surplus. Only a board of directors' resolution is needed to purchase shares with earned surplus,<sup>124</sup> but if capital surplus is to be used, the shareholders must approve the transaction by a two-thirds vote.<sup>125</sup> When purchased, the shares become treasury shares,<sup>126</sup> but the purchase does not reduce the stated capital of the corporation unless and until the shares are formally can-

<sup>116</sup> TEX. BUS. CORP. ACT ANN. art. 2.29D(2), as amended, (Supp. 1968).

<sup>117</sup> *Id.* art. 2.13 (1956).

<sup>118</sup> *Id.* art. 4.10A.

<sup>119</sup> *Id.* art. 4.09.

<sup>120</sup> *Id.* art. 4.08.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.* art. 4.10A.

<sup>123</sup> *Id.* art. 2.03B.

<sup>124</sup> *Id.* art. 2.03C.

<sup>125</sup> *Id.* art. 2.03D.

<sup>126</sup> *Id.* art. 1.02(9).

celled.<sup>127</sup> This may be an important consideration in determining the corporate franchise tax under the Texas Franchise Tax Statute,<sup>128</sup> since part of that tax is based on the stated capital of the corporation. Thus, it may be advantageous to reduce the stated capital (and thereby the tax) of the corporation by reacquiring shares and filing a cancellation thereof (amendment is not necessary under TBCA articles 4.10 and 4.11) with the Secretary of State's office to cancel the shares.

*Restrictions on the Transferability of Shares.* Even though most securities transactions are carried on under concepts of free transferability, there may be instances, especially in the close corporation situation, in which restrictions upon the transferability of shares is desirable.<sup>129</sup> Any corporation may impose a restriction on the sale or other disposition of its shares provided the restriction (1) is set forth in the articles of incorporation or bylaws of the corporation, (2) is copied at length or in summary form on the face of each stock certificate affected (if in summary form, the restriction must be copied at length on the back of the certificate and properly referred to on the face thereof), and (3) does not unreasonably restrain or prohibit transferability.<sup>130</sup> In lieu of setting forth the restriction at length on the face or back of the certificate, such restriction may be incorporated by reference on the face or back of the certificate if the applicable parts of the articles of incorporation, bylaws, resolution, or agreement embodying the full restriction is filed with the Secretary of State.<sup>131</sup> This latter procedure has proven fairly popular in Texas as there are several hundred such papers presently filed with the Secretary of State.<sup>132</sup> The popularity of this device stems from the inability of most Texas lawyers (the authors included) to satisfactorily summarize both restrictions on transferability of stock and a buy-sell agreement in the approximately 150 words that one can squeeze onto the back of a stock certificate.

Generally speaking, in order for the restriction to be valid, it must be reasonable in nature. Furthermore, there must be a legitimate business purpose for imposing the restriction, with adequate notice thereof to the shareholder.<sup>133</sup> Reasonable restrictions include those defining (1) the preemptive or prior rights of the corporation or its shareholders to purchase any shares offered for transfer, (2) the rights and obligations of the holders of any class of stock, composed of no more than twenty holders, under a buy and sell agreement, and (3) the rights of the corporation or of any other per-

<sup>127</sup> See *id.* arts. 2.03E, 4.10A, 4.11.

<sup>128</sup> TEX. TAX-GEN. ANN. art. 12.01, as amended, (Supp. 1968).

<sup>129</sup> See Castle, *supra* note 83, for a concise and thorough discussion on restricting the transferability of securities in Texas.

<sup>130</sup> TEX. BUS. CORP. ACT ANN. art. 2.22A, as amended, (Supp. 1968).

<sup>131</sup> *Id.* art. 2.19F (1956). The Secretary of State will not accept the entire by-laws for filing, only the applicable parts; however, the Secretary will accept the entire buy-sell agreement for filing.

<sup>132</sup> Lecture by Ivon Lee, Legal Counsel, Office of the Secretary of State, presented at Southern Methodist University School of Law, Mar. 2, 1968.

<sup>133</sup> Legitimate corporate business purposes which have been generally approved include the corporate desire to prohibit a shareholder who is indebted to the issuer from transferring his shares before satisfying his debt to the corporation, and the corporate desire to have persons who are sympathetic with the purposes for which the corporation was organized hold its shares. See Castle, *supra* note 83.

son granted an option or right of first refusal to purchase the shares of the corporation.<sup>134</sup> These foregoing restrictions are deemed reasonable by statute and are thus upheld by the courts.<sup>135</sup> Unreasonable restrictions might include those which require the directors' consent before the shares may be transferred but which do not establish any criteria for the granting or withholding of such consent, and those giving the directors the option to purchase the shares at a price to be fixed by them *in their sole discretion*.<sup>136</sup>

Even though the restriction is reasonable, it must be adequately communicated to the shareholder to be binding on him. As indicated previously, article 2.22A of the TBCA requires that such restriction be set forth in the articles of incorporation or the bylaws *and* copied at length or in summary form on the face of each certificate affected, unless such restriction is incorporated by reference on the certificate and filed with the Secretary of State in accordance with the provisions of article 2.19F of the TBCA. Moreover, section 8.204 of the Texas Business and Commerce Code provides: "Unless noted conspicuously on the security a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it."<sup>137</sup> Thus, the effect of these provisions is to place upon the issuer the duty of properly noting the restriction on its certificates and of otherwise communicating such information to the prospective shareholders. If the restriction is not properly noted on the certificate and if the purchaser has no actual knowledge of the restriction, it is apparent that such purchaser acquires the security free of any restrictions thereon.

Statistics from the office of the Secretary of State indicate that restrictions on the transferability of shares in Texas are rarely placed in the articles of incorporation,<sup>138</sup> and are probably more often found in the bylaws. From *Sandor Petroleum Corp. v. Williams*<sup>139</sup> it is apparent that a corporation may not unilaterally place restrictions on transferability upon any of its shares which are already outstanding in the hands of its shareholders through an amendment to the bylaws, unless the shareholders agree, because to allow such would destroy a vested right which its shareholders had acquired in the shares they hold.<sup>140</sup> The authors doubt whether the restrictions would be upheld even if in the form of an amendment to the articles if there were some shareholders who disagreed with the amendment. Pre-

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<sup>134</sup> TEX. BUS. CORP. ACT ANN. art. 2.22B (1956).

<sup>135</sup> See *Casteel v. Gunning*, 402 S.W.2d 529 (Tex. Civ. App. 1966), *error ref. n.r.e.*; *Pomilla v. Bumgardner*, 326 S.W.2d 917 (Tex. Civ. App. 1959); *Coleman v. Kettering*, 289 S.W.2d 953 (Tex. Civ. App. 1956).

<sup>136</sup> See, e.g., *Howe v. Roberts*, 209 Ala. 80, 95 So. 344 (1923).

<sup>137</sup> TEX. BUS. & COMM. CODE ANN. § 8.204 (1968).

<sup>138</sup> Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, only 31 (or 3.1%) contained restrictions on the transfer of shares.

<sup>139</sup> 321 S.W.2d 614 (Tex. Civ. App. 1959), *error ref. n.r.e.*

<sup>140</sup> In *Williams*, the corporation sought to impose a restriction on the transferability of its shares by amending its bylaws after a number of the shares had been issued. The court held that even though such a restriction (giving the corporation a right of first refusal) was reasonable within the meaning of TEX. BUS. CORP. ACT ANN. art. 2.22B (1956), the restriction was not effective as to those shares already outstanding because the shareholders had acquired a vested right in their free transferability which could not be affected by the unilateral action of the corporation.



sumably the court might hold that vested rights can only be changed by express consent of all parties. Thus, it is advisable to establish restrictions on the transferability of shares at the time of incorporation in accordance with the procedure noted above.

*Amendment to the Articles of Incorporation.* Article 4.02 of the TBCA suggests the procedure for amending the articles of incorporation, and generally the following steps may be followed:<sup>141</sup> (1) the board of directors must adopt a resolution setting forth the proposed amendment and directing that it be submitted to a vote at either an annual or a special meeting of the shareholders, (2) written or printed notice of the proposed amendment must be given to each shareholder entitled to vote thereon not less than ten nor more than fifty days before the date of the meeting,<sup>142</sup> and (3) the shareholders must approve the amendment by an affirmative vote of two-thirds of the shares entitled to vote thereon. In 1967, article 4.02 was amended to allow the amending of the articles of incorporation "by the unanimous written consent of the incorporators of a corporation which has not commenced business and which has not issued any shares or accepted any subscriptions."<sup>143</sup> This change was designed to meet the needs of the situation in which, after the articles of incorporation have been filed, the incorporators find it necessary to amend them before any shares have been issued.

*Shareholder Quorum and Voting Requirements.* Article 2.28 of the TBCA provides that unless the articles of incorporation specify otherwise, the holders of a majority of the shares entitled to vote constitute a quorum, but in no event shall a quorum consist of the holders of less than one-third of the shares entitled to vote. Thus, it is possible to provide in the articles of incorporation for a quorum requirement of as much as 100 per cent or as little as thirty-three and one-third per cent of the shares entitled to vote. This, then, is an "optional mandatory" provision because if nothing is said in the *articles of incorporation* about shareholder quorum requirements, a majority of the shares entitled to vote constitutes a quorum. A *bylaw* is ineffective to change the quorum requirements under this article.

Article 2.28 also provides that a vote of a majority of the shares entitled to vote and represented at a meeting at which a quorum is present is sufficient to take *shareholder action*, unless the vote of a greater number is required by law, the articles of incorporation, or the bylaws. Thus, where a majority vote is required under the statute to take specific shareholder action, the articles of incorporation or the bylaws may effectively require a greater-than-majority vote for such action. On the other hand, however, where either the statute or the articles of incorporation require a greater-than-majority vote for specific shareholder action, a bylaw requiring a

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<sup>141</sup> See TEX. BUS. CORP. ACT ANN. art. 4.02A, as amended, (Supp. 1968).

<sup>142</sup> See *id.* art. 2.25A (1956).

<sup>143</sup> *Id.* art. 4.02C (Supp. 1968).

greater number is ineffective because it would be in conflict with the statute or the articles of incorporation.<sup>144</sup>

Of broader application is article 9.08 of the TBCA which provides that if the articles of incorporation call for a greater voting requirement than is required by the statute with respect to specific shareholder action, "the articles of incorporation shall control." Thus, for any given type of shareholder action, the articles of incorporation may validly require a greater vote (up to 100 per cent of the shares entitled to vote thereon) than is required by the statute; however, the articles may never provide for a smaller vote than is required by statute because to do so would render the articles in conflict with the statute. The TBCA may be viewed as setting the minimum floor on the voting requirement for given shareholder action, and by virtue of article 9.08, the articles of incorporation may increase this shareholder voting requirement above the statutory norm. But the articles may never reduce the voting requirement below the minimum statutorily required floor.

These greater-than-majority (high) shareholder quorum and voting requirements may prove beneficial, especially in the close corporation in which the majority owners wish to make their position more secure by making it more difficult for the minority to impinge upon their control. However, high quorum or voting requirements offer one inherent disadvantage: the higher the quorum and/or voting requirements, the greater the chance that no corporate action will be taken because the necessary quorum or vote is not forthcoming.

*Executive Committee.* If the articles of incorporation or the bylaws so provide, a majority of the total number of the board of directors may designate two or more directors to constitute an executive committee which may exercise all of the authority of the board in the business affairs of the corporation except where the action of the board is specified by the TBCA or other applicable law.<sup>145</sup> However, this delegation of authority to the executive committee will not relieve the board of directors or any member thereof of any responsibility imposed upon the board or the individual member by law. Even though article 2.31 of the TBCA provides that the business and affairs of a corporation shall be managed by a board of directors, the Supreme Court of Texas has held that the board of directors may delegate to the executive committee (or to subordinate officers or agents) the power to perform any act within the business affairs of the corporation which the board itself could legally perform, even though the performance of such an act involved the exercise of the highest judgment and discretion.<sup>146</sup> Any member of the executive committee, or any officer or agent of the corporation, elected or appointed by the board of directors, may be removed by the board of directors when in the board's judgment the best interests of the corporation would be served thereby.<sup>147</sup>

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<sup>144</sup> See *Comment of Bar Committee*, 3A TEX. REV. CIV. STAT. ANN. 414 (1956).

<sup>145</sup> TEX. BUS. CORP. ACT ANN. art. 2.36A (1956).

<sup>146</sup> *San Antonio Joint Stock Land Bank v. Taylor*, 129 Tex. 335, 105 S.W.2d 650 (1937).

<sup>147</sup> TEX. BUS. CORP. ACT ANN. art. 2.43A (1956).

*Interested Officer and Director Transactions.* Since the director stands in a fiduciary relationship to his corporation, transactions with the corporation in which the director has a personal interest often raise questions of propriety. Even though a director or officer of a corporation is not disqualified from dealing with his corporation,<sup>148</sup> it may often be desirable to include in the articles of incorporation a provision giving the director or officer permission to engage in transactions with his corporation in which he has a personal interest, provided he makes full disclosure of his interest therein. Such a provision should be used to clarify the relationship of the interested director with his corporation so that confusion will be avoided in the long run. Although the provision offers advantages, it does not appear to be in popular use in Texas.<sup>149</sup> Even in the absence of such a provision in the articles, contracts between the corporation and its directors or officers are not void but are merely voidable if unfair or fraudulent, with the burden resting upon the fiduciary (director or officer) to prove fairness.<sup>150</sup>

### C. Executing and Filing the Articles of Incorporation

The articles of incorporation must be *verified* by the incorporators.<sup>151</sup> The attorney should be sure that the notary's statement includes the words "duly sworn," because if the incorporators merely "acknowledge" rather than "verify" (or swear) that the statements contained therein are true, the articles will be rejected.

One should remember that duplicate originals of the articles of incorporation,<sup>152</sup> accompanied by a fee of \$100,<sup>153</sup> must be filed with the Secretary of State. If the Secretary of State is satisfied that the articles conform to law, he will issue a certificate of incorporation and will deliver this certificate and one of the duplicate originals of the articles to the incorporators or their representatives.<sup>154</sup> Upon the issuance of this certificate of incorporation, the corporate existence begins, and the certificate is conclusive evidence that the incorporators have performed all conditions precedent to incorporation under the TBCA.<sup>155</sup>

After the certificate of incorporation is issued, the corporation "[may] not transact any business or incur any indebtedness, except . . . as . . . incidental to its organization or to obtaining subscriptions to or payment for its shares, until it has received for the issuance of shares consideration of the value of at least One Thousand Dollars (\$1,000.00), consisting of

<sup>148</sup> *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W.2d 715 (1961).

<sup>149</sup> Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, only 69 (or 6.9%) contained an interested director clause.

<sup>150</sup> *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963).

<sup>151</sup> TEX. BUS. CORP. ACT ANN. art. 3.01A (1956).

<sup>152</sup> *Id.* art. 3.03A.

<sup>153</sup> *Id.* art. 10.01A(1) (Supp. 1969) (effective Sept. 1, 1969). A certified copy of the charter, or any other document filed for record with the Secretary of State by anyone, may be had for the payment of \$1.00 per page, plus \$1.00 for certification. The customary need for a certified copy of one's own charter would occur when the corporation intends to immediately qualify to do business in another state.

<sup>154</sup> See *id.* art. 3.03 (1956), for details of this procedure. One additional requirement that the attorney should make sure is attended to is applying for an employer's identification number, as this will be the number used for payment of the annual franchise tax.

<sup>155</sup> *Id.* art. 3.04A.

money, labor done, or property actually received."<sup>156</sup> This \$1,000 minimum is the only test of whether a corporation has received sufficient consideration for its shares before beginning business.<sup>157</sup> Thus, a corporation may obtain its charter from the Secretary of State before receiving \$1,000, but it may not *begin* business operations before \$1,000 in money, labor done, or property is actually received by the corporation. If business is begun before this is received then the shareholders and officers are in effect engaged in a partnership and will be personally liable.

### III. DRAFTING THE BYLAWS

Since the bylaws of a corporation differ from the charter in many respects,<sup>158</sup> the question in drafting the bylaws becomes one of what provisions to place therein. This question takes on importance when the draftsman remembers that normally the bylaws are easier to change than the charter. Thus, placing something in the charter may mean that it is more or less permanently solidified in the corporate structure, in addition to being open to official scrutiny and public inspection; whereas, if the provision were placed in the corporate bylaws, this would not necessarily be the case.

Paralleling the considerations involved in drafting the corporate purpose clause are the two approaches in drafting the bylaws. The first approach is that the less said in the bylaws, the better, since nothing there can increase the powers of the corporation but rather may serve to limit. If the draftsman adheres to this approach, the bylaws need only include those provisions required by the applicable statute. The other approach provides that it is a help to management and a safeguard to legal procedure if the bylaws set out what amounts to an operating manual of basic rules for ordinary transactions, whether derived from statute or from the charter. As one expert notes, the bylaws constitute a "working document" and thus should be made "sufficiently complete to be relied upon by the officers of the corporation as almost a check list in administering the affairs of the corporation even though this results in bylaws which paraphrase statutory requirements. The theory of this check list approach is that clients will read the bylaws but not the statutes."<sup>159</sup>

Since the function of the bylaws is to provide a pattern for the internal operation of the corporation, the draftsman should attempt to provide corporate officers and directors with a workable and accurate guide so as to facilitate their handling of corporate affairs. A compromise between the two preceding approaches has been suggested. The compromise arrangement provides for an inclusion of applicable statutes and charter provisions in a supplement or addendum to the bylaws themselves. This supplement could easily reflect any legislative changes or charter amendments.<sup>160</sup>

<sup>156</sup> *Id.* art. 3.05A (Supp. 1968).

<sup>157</sup> See *Comment of Bar Committee*, 3A TEX. REV. CIV. STAT. ANN. 50, 51 (Supp. 1968).

<sup>158</sup> See Section I of this Article *supra*.

<sup>159</sup> G. SEWARD, BASIC CORPORATE PRACTICE 47 (1966).

<sup>160</sup> H. HENN, CORPORATIONS 182 (1961).

No matter which approach is chosen by the draftsman, the bylaws in the end really supplement the charter, "filling in its skeleton structure with details not important enough to be publicly filed."<sup>161</sup> They may contain a wide variety of provisions subject only to the requirement that they be consistent with the charter and the mandatory provisions of other relevant laws. The TBCA provides that the initial bylaws of the corporation must be adopted by the board of directors at an organizational meeting held after the issuance of the charter,<sup>162</sup> and that any provision required or permitted by the Act to be set forth in the bylaws may be set forth in the charter.<sup>163</sup> Thus, under Texas law the bylaws should be drafted to meet the flexible needs of the corporate client in question. In this regard, the following discussion is designed to cover some of the more important provisions which should be included in the bylaws.

*Shareholders.* A number of items relevant to the shareholders should perhaps be covered in the bylaws. For example, subsequent power to change the bylaws is statutorily vested in the shareholders, but such power may be delegated by the shareholders to the board of directors.<sup>164</sup> Thus, it is desirable to spell out in the bylaws whether the shareholders or the board of directors have the initial power to alter or amend the bylaws,<sup>165</sup> which the shareholders will ratify at the first meeting. In addition, a full description of the shareholder meeting procedure should be set forth in the bylaws, including the time and place of the annual shareholder meeting<sup>166</sup> and the time, place, and procedure for calling a special shareholder meeting.<sup>167</sup> If it is desired that shareholder meetings, either annual or special, be held at any place other than the registered office of the corporation, the bylaws must designate a reasonable place within or without the State of Texas. Special meetings of the shareholders *may* be called by the president, the board of directors, the holders of at least one-tenth of the shares entitled to vote at the meetings, or such other officers or persons as provided in the articles of incorporation or the bylaws.<sup>168</sup>

Written notice of the shareholder meeting must be given to each shareholder entitled to vote at such meeting not less than ten nor more than fifty days before the date of such meeting.<sup>169</sup> Thus, the procedure and the nature of the notice to be given regarding the shareholder meeting should be covered in the bylaws. This requirement of notice of the shareholder meeting is for the benefit of the shareholders, and they may waive this notice in writing before or after the meeting or by attending and partici-

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<sup>161</sup> 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE 348 (1959).

<sup>162</sup> TEX. BUS. CORP. ACT ANN. art. 2.23 (1956); see *id.* art. 3.06.

<sup>163</sup> *Id.* art. 3.02A(9), as amended, (Supp. 1968).

<sup>164</sup> *Id.* art. 2.23 (1956).

<sup>165</sup> Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, only 113 (or 11.3%) contained a provision giving the directors the power to amend the bylaws.

<sup>166</sup> TEX. BUS. CORP. ACT ANN. art. 2.24A, B (1956). See generally Kerr & Wolf, *Shareholders' Meetings Under the Texas Business Corporation Act*, 43 TEXAS L. REV. 713 (1965).

<sup>167</sup> TEX. BUS. CORP. ACT ANN. art. 2.24C (1956).

<sup>168</sup> *Id.*

<sup>169</sup> *Id.* art. 2.25.

pating in the improperly called meeting without protest.<sup>170</sup> A voting list of the shareholders entitled to vote at the meeting should be prepared by the person in charge of the stock transfer books at least ten days before each meeting of the shareholders.<sup>171</sup> Such a list is open to inspection by the shareholders at all times during the meeting. Thus, the bylaws should make provision for the preparation of the voting lists of the shareholders.

Other provisions relative to the shareholders which may be covered by the bylaws include the provision of greater-than-majority quorum<sup>172</sup> and voting<sup>173</sup> requirements for shareholder meetings. Of course, provision for a greater-than-majority shareholder *quorum* requirement *must* be made in the articles of incorporation, but it is not improper to repeat such a provision in the bylaws. Provision for a greater-than-majority shareholder *voting* requirement, at a meeting at which a *quorum* is present, *may* be made in either the articles of incorporation or the bylaws.<sup>174</sup> Moreover, the bylaws should prescribe the procedure to be followed in closing the transfer books and establishing the record date to determine the shareholders entitled to notice of and to vote at any shareholder meeting, and the shareholders entitled to a dividend. The transfer books may be closed not more than fifty days nor less than ten days immediately preceding either the meeting, or the date upon which the action calling for a closing of the transfer books is taken. If the transfer books are not closed and no record date is fixed, the date on which the notice of the meeting is mailed or the date on which the resolution of the board of directors declaring a dividend is adopted becomes in effect the record date for the determination of appropriate shareholders.<sup>175</sup>

Perhaps the bylaws should also contain a provision regarding the voting of shareholders by proxy. Normally, a shareholder may vote either in person or by a proxy executed by him or his duly authorized agent. However, no proxy is valid for more than eleven months from the date of its execution unless otherwise provided in the proxy, and such proxy is revocable unless expressly provided therein to be irrevocable and unless otherwise made irrevocable by law.<sup>176</sup> "The 1961 addition of the words 'and unless otherwise made irrevocable by law' to Art. 2.29C makes it clear that, to be irrevocable, a proxy must not only so state but must also satisfy the requisites of irrevocability under the common law, such as by being coupled with an interest or by being given as security."<sup>177</sup> Moreover, the registration of securities and proxy solicitations for corporations engaged in interstate commerce, businesses affecting interstate commerce, corporate securities traded by any means or instrumentality of interstate commerce, or corporations having at least 500 shareholders of record and over \$1

<sup>170</sup> *Camp v. Shannon*, 162 Tex. 515, 348 S.W.2d 517 (1961); see TEX. BUS. CORP. ACT ANN. art. 9.09 (1956).

<sup>171</sup> TEX. BUS. CORP. ACT ANN. art. 2.27A (1956).

<sup>172</sup> *Id.* art. 2.28.

<sup>173</sup> *Id.* art. 2.29, as amended, (Supp. 1968).

<sup>174</sup> *Id.* art. 2.28 (1956). See also *id.* art. 2.29, as amended, (Supp. 1968); text accompanying note 144 *supra*.

<sup>175</sup> TEX. BUS. CORP. ACT ANN. art. 2.26 (1956).

<sup>176</sup> *Id.* art. 2.29C, as amended, (Supp. 1968).

<sup>177</sup> *Comment of Bar Committee*, 3A TEX. REV. CIV. STAT. ANN. 35 (Supp. 1968).

million in total assets must comply with section 12(g)(1) of the Securities Exchange Act of 1934 and regulation 14A thereunder.

Finally, the bylaws may cover the shareholders' right to inspect and examine the books and records of the corporation. Any person who has been a shareholder for at least six months immediately preceding his demand, or who is the holder of at least five per cent of all the outstanding shares of the corporation, upon written demand stating a reasonable and proper purpose therefor, has the right to examine the books of the corporation at any reasonable time and to make extracts therefrom.<sup>178</sup> Even though a shareholder's right to inspect the books is not absolute in nature, in that a proper purpose therefor must be shown,<sup>179</sup> this section is designed to make it clear that the shareholder's common law right to examine the corporate records is not restricted;<sup>180</sup> enforcement of this right may be by mandamus.<sup>181</sup>

*Directors.* The bylaws should also contain various provisions regarding the directors of the corporation. A Texas corporation must have at least three directors. Subject to this requirement, the number of directors should be established by the bylaws (except that the number of the initial board of directors is set by the articles of incorporation).<sup>182</sup> If the bylaws do not state the number of directors, the number shall be the same as that stated in the articles of incorporation. The best procedure is to declare the number of directors through a bylaw provision, which usually may be amended by the majority vote of the directors or the shareholders, because if absolutely fixed by the articles of incorporation, the number of directors may be changed only by an amendment to the articles which requires an affirmative vote of the holders of two-thirds of the shares entitled to vote thereon. If covered in the bylaws, the number of directors may be increased or decreased by amendment to the bylaws, but no decrease may abbreviate the term of any incumbent director. Regarding amendment procedure, it has been held that the action of the shareholders in electing four directors for four successive years resulted in an "amendment" of the original bylaw provision for three directors so as to then provide for four directors.<sup>183</sup> However, if the number of directors was controlled only by the articles of incorporation, such a de facto amendment to the articles would not be effective unless approved by an affirmative vote of the holders of two-thirds of the shares entitled to vote thereon and unless the procedure of TBCA article 4.02 were followed.

The qualifications of the members of the board of directors should be

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<sup>178</sup> TEX. BUS. CORP. ACT ANN. art. 2.44B (1956).

<sup>179</sup> Guaranty Old Line Life Co. v. McCallum, 97 S.W.2d 966 (Tex. Civ. App. 1936); Dreyfuss & Son v. Benson, 239 S.W. 347 (Tex. Civ. App. 1922), *error ref.*

<sup>180</sup> Texas Infra-Red Radiant Co. v. Erwin, 397 S.W.2d 491 (Tex. Civ. App. 1965), *error ref.*

*n.r.c.*

<sup>181</sup> Uvalde Rock Asphalt Co. v. Loughridge, 425 S.W.2d 818 (Tex. 1968).

<sup>182</sup> TEX. BUS. CORP. ACT ANN. art. 2.32 (1956). *See also id.* art. 3.02A(11), *as amended*, (Supp. 1968). Statistics from the Texas Secretary of State's office show that out of a sample of 1,000 charters filed in 1968, approximately 805 (or 80.5%) provided for a 3-man board of directors, 16% used a 4-man board, 2% used a 5-man board, and 0.4% used a 6-man board.

<sup>183</sup> Keating v. K-C-K Corp., 383 S.W.2d 69 (Tex. Civ. App. 1965).

prescribed by the bylaws. The directors need not be residents of Texas unless the articles or the bylaws so require, and the articles or the bylaws may prescribe other qualifications for the directors.<sup>184</sup> The term of each member of the board of directors should be made clear by the bylaws. The shareholders elect the directors, and each director holds office until his death or until his successor is elected at a shareholder meeting, unless (a) the directors are classified as permitted by TBCA article 2.33, or (b) the specific director is removed, prior to the expiration of his term, in accordance with the provisions of the bylaws. Article 2.33 of the TBCA provides that, if the board of directors consists of nine or more members, such directors may be divided into two or three classes as nearly equal in number as possible at the first annual meeting of the shareholders (or at any meeting subsequent to the first annual meeting, but not prior thereto), and the members of only one class of such directors may be elected at each succeeding annual meeting. In effect, the directors may be divided into classes and given staggered terms of office, thus promoting some continuity of experience.

Provision for the removal of a director and the procedure to be followed in taking such action should be covered in the bylaws. The language of TBCA article 2.32—"Unless removed in accordance with the provisions of the bylaws"—indicates that a director may be removed for cause, provided that the reason and the procedure prescribed by the bylaws for such removal are followed. It is also possible to provide in the bylaws for the removal of a director without cause. Thus, directors may be removed at any time, for cause or without cause, provided that such removal is authorized by the bylaws.<sup>185</sup>

The procedure for filling a vacancy in the board of directors should be prescribed in the bylaws. Article 2.34 of the TBCA provides that any vacancy in the board *may* be filled by an affirmative vote of a majority of the remaining directors even though this number is less than a quorum of the whole board. Thus, it is possible to provide in the bylaws that a greater-than-majority vote of the remaining board is necessary to fill a vacancy in the board. The statute provides that if the vacancy is filled, it shall be filled only for the unexpired term of the predecessor in the directorship.<sup>186</sup> In addition, another qualification is placed upon the filling of a vacancy in the board: any vacancy created by an increase in the number of directors must be filled by the shareholders, not the directors.

*Director Meetings.* Normally the directors act through a formal meeting of the board; therefore, it is desirable to spell out in the bylaws the details of the regular director meeting, such as the time, place, and provision for notice. Regular board meetings may be held with or without notice as prescribed in the bylaws; however, special board meetings must be held

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<sup>184</sup> TEX. BUS. CORP. ACT ANN. art. 2.31 (1956).

<sup>185</sup> *Comment of Bar Committee*, 3A TEX. REV. CIV. STAT. ANN. 128 (1956). If the director was elected through cumulative voting it may be held unfair to remove this director without cause. There is no law on this point in Texas.

<sup>186</sup> TEX. BUS. CORP. ACT ANN. art. 2.34 (1956).



upon such notice as provided in the bylaws.<sup>187</sup> The required notice of a board meeting may be waived either by the attendance of the director at the meeting, unless he attends for the special purpose of objecting to the transaction of any business because the meeting was improperly convened,<sup>188</sup> or by written waiver of such notice executed by a director either before or after the meeting.<sup>189</sup> In 1967 article 9.10 of the TBCA was amended to authorize the propriety of informal action taken by the board of directors (or an executive committee) in the absence of a formal meeting, provided that *unanimous written consent* thereto was given by the board (or the committee).<sup>190</sup> This was the first time informal board action had been sanctioned by statute in Texas. However, such authority of the board to act informally may be restricted by the articles of incorporation or the bylaws.

The quorum and voting requirements of the board of directors should be covered in the bylaws, but it is not improper to cover the subject in the articles of incorporation. "A majority of the number of directors fixed by the bylaws, or, in the absence of a bylaw fixing the number of directors, a majority of the number stated in the articles of incorporation [constitutes] a quorum for the transaction of business unless a greater number is required by the articles of incorporation or the bylaws."<sup>191</sup> Therefore, if nothing is said in either the articles or the bylaws regarding director quorum and voting requirements, a majority of the whole board constitutes a quorum and a majority of those present at a meeting having a quorum is sufficient to transact the business of the board. However, greater-than-majority director quorum and/or voting requirements may be prescribed by the articles or the bylaws, and it is conceivable that either or both requirements may be as high as one hundred per cent.

*Officers.* Since ordinarily the corporation can act only through its officers and agents,<sup>192</sup> the various officers of the corporation along with the respective term, authority, duties, and qualifications of each office should be spelled out in the bylaws. The officers must include at least a president, a vice president, a secretary, and a treasurer, as elected from time to time by the board of directors in the manner prescribed in the bylaws.<sup>193</sup> Generally, any two or more offices of the corporation may be held by the same person, except that the president and secretary shall not be the same person, presumably because one of these officers may be called upon to verify the power or position of the other. Furthermore, provision should be made in the bylaws for the procedures to be followed upon the vacancy of an office by the removal, resignation or death of an officer. It should be noted that when the bylaws of the corporation specify a term for a given

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<sup>187</sup> *Id.* art. 2.37B.

<sup>188</sup> *Id.*

<sup>189</sup> *Id.* art. 9.09.

<sup>190</sup> *Id.* art. 9.10B, as amended, (Supp. 1968).

<sup>191</sup> *Id.* art. 2.35 (1956).

<sup>192</sup> *Radio KBUY, Inc. v. Lieurance*, 390 S.W.2d 16, 17 (Tex. Civ. App. 1965).

<sup>193</sup> TEX. BUS. CORP. ACT ANN. art. 2.42A (1956).

corporate office, a person may not be employed to fill that office for a longer period of time than that specified in the bylaws.<sup>194</sup>

*Interested Officers and Director Transactions.* Provision may also be made in the bylaws granting permission to the officers and directors to engage in transactions with the corporation in which one or more of the directors has a personal interest. Even though such permission may have been given in the articles of incorporation, it is not improper to repeat it in the bylaws, and if such a provision is not covered in the articles, it should be covered in the bylaws.<sup>195</sup> A provision of this sort, whether contained in the articles or bylaws, is of dubious legal effect since the intended transaction is still voidable for unfairness or fraud, with the burden resting upon the officer or director to prove otherwise.<sup>196</sup>

*Compensation and Indemnification of Officers and Directors.* Provision should be made in the bylaws for the manner and amount of compensation to be given each officer and director of the corporation. Moreover, it is good practice to provide in the bylaws for the indemnification by the corporation of the officers, directors, and other corporate personnel for reasonable litigation expenses incurred by them in defending litigation arising out of their execution of their official corporate capacity. There are limits on such reimbursements; they could not, for example, be reimbursed if they were eventually adjudged to have done wrong, and a provision granting such would not be upheld. In regard to bylaw provisions designed to benefit the officers or directors, the TBCA specifically prohibits the loan of money by the corporation to its officers and directors, even though such a loan is permissible if made to an employee of the corporation,<sup>197</sup> and the directors who voted for or assented to the ultra vires loan of money<sup>198</sup> by the corporation to an officer or director are jointly and severally liable to the corporation for the amount of the loan until it is repaid.<sup>199</sup>

*Other Provisions.* Since the bylaws of a corporation constitute a manual for the management of the internal affairs of the corporation, a number of additional provisions may be included therein. Provisions may be made in the bylaws for accounting matters such as the fiscal year and the books and records of the corporation,<sup>200</sup> and the handling of a deadlock or the dissolution of the corporation.<sup>201</sup>

*Items Which Should Not Be Specifically Included in the Charter or the Bylaws.* Very often it is advisable not to include certain items in either

<sup>194</sup> *Pioneer Specialties, Inc. v. Nelson*, 161 Tex. 244, 339 S.W.2d 199 (1960).

<sup>195</sup> TEX. BUS. CORP. ACT ANN. art. 2.42B (1956).

<sup>196</sup> *Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 568 (Tex. 1963).

<sup>197</sup> See TEX. BUS. CORP. ACT ANN. art. 2.02A(6) (1956).

<sup>198</sup> *Republic Nat'l Bank v. Whitten*, 383 S.W.2d 207 (Tex. Civ. App. 1964), *aff'd*, 397 S.W.2d 415 (Tex. 1965).

<sup>199</sup> TEX. BUS. CORP. ACT ANN. art. 2.41A(4) (1956).

<sup>200</sup> See *id.* art. 2.44A.

<sup>201</sup> See *id.* arts. 6.02, 6.03, as amended, (Supp. 1968).

the charter or the bylaws. For example, specific details regarding the capital structure or the forms of the stock certificates of the corporation included in either of the two basic corporate documents would unduly retard the making of changes in such items as circumstances demand because such a change would have to be effected by an amendment to the charter or the bylaws. The normal practice is to place the matters in the minutes of the directors' meetings. It is true that inclusion of such items in the bylaws would eliminate any question regarding whether or not such had been approved by the appropriate corporate authority; however, if complete and appropriate corporate minutes are kept, the same result is achieved.

#### IV. SPECIAL CONSIDERATIONS AND CONTROL DEVICES FOR THE CLOSE CORPORATION

The small or close corporation presents a special problem in regard to the drafting of corporate charters and bylaws. This is fundamentally due to a failure on the part of legislators and courts to recognize that the nature and methods of operation, and thus the rules of operation, for the close corporation are often very different from those of the publicly held corporation. In this country, "with but few exceptions, corporation statutes have been drafted with publicly held corporations in mind and little effort has been made to meet the needs of close corporations."<sup>202</sup> Whether separate, comprehensive statutes expressly directed toward the peculiar problems of the close corporation *should* in fact be promulgated—a significant area of discussion in itself<sup>203</sup>—is not within the scope of this Article.

The important point is that the draftsman must remember that the close corporation differs materially in its characteristics and needs from the large, public-issue corporation; thus the attorney should carefully scrutinize the statutes when drafting articles and bylaws because all of them are generally geared to the "big" corporation. As one observer aptly warns, "close corporations frequently present problems requiring unique solutions—solutions not to be found in the orthodox phraseology of corporate forms."<sup>204</sup> The same observer enumerates certain major areas of possible variance between the needs and the desires of the close corporation and the public corporation: (1) general authority of directors, (2) preemptive rights, (3) transfer of shares, (4) quorum and voting requirements for

<sup>202</sup> F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE 27 (1958).

<sup>203</sup> See Adickes, A "Closed Corporation Law" for California, 54 CALIF. L. REV. 1990 (1966); Bradley, *Toward a More Perfect Close Corporation—The Need for More and Improved Legislation*, 54 GEO. L.J. 1145 (1966); Oppenheim, *The Close Corporation in California—Necessity of Separate Treatment*, 12 HAST. L.J. 227 (1961); Prunty, *Business Association*, 1959 Survey of New York Law, 34 N.Y.U.L. REV. 1425 (1959); Rutledge, *Significant Trends in Modern Incorporation Statutes*, 22 WASH. U.L.Q. 305 (1937); Winer, *Proposing a New York Close Corporation Law*, 28 CORNELL L.Q. 313 (1943); Wolens, *A Round Peg—A Square Hole: The Close Corporation and the Law*, 22 SW. L.J. 811 (1968). See also Note, *Statutory Assistance for Closely Held Corporations*, 71 HARV. L. REV. 1498 (1958); Note, *A Plea for Separate Statutory Treatment of the Close Corporation*, 33 N.Y.U.L. REV. 700 (1958).

<sup>204</sup> Dykstra, *Molding the Utah Corporation: Survey and Commentary*, 7 UTAH L. REV. 102 (1960).

shareholders' and directors' meetings, (5) removal of directors, (6) amendment authority, (7) conflict of interest matters, (8) power to dispose of corporate property, and (9) means by which corporate deadlocks can be resolved.<sup>205</sup>

The draftsman should readily perceive that the wording of the articles or the bylaws in regard to any of the above items will be prompted by different policy considerations, depending on whether a close or public corporation is involved. For example, restrictions on the transferability of shares and preemptive rights are almost always desirable in the close corporation; however, the converse is usually true in the large, public corporation. Another example revolves around the problem of the oppression of minority shareholders (*i.e.*, the "squeeze play") so common in close corporations. The draftsman can attempt to prevent such a situation by appropriate charter or bylaw provisions stipulating greater-than-majority voting requirements regarding shareholder and/or director action. However, such a high voting requirement may in turn easily lead to deadlock in the small corporation, a consideration militating against its use. This difficulty can in turn be planned for by the insertion of an arbiter or deadlock-breaking director provision, or by separate shareholder agreement providing for the appointment of an arbiter.

Finally, consideration should be given to whether a particular provision or clause should be inserted in the charter or bylaws or, perhaps, in a third document. For example, the draftsman must decide whether to place restrictions on the transfer of shares (almost always desirable in the close corporation) in the charter, bylaws, separate shareholders' agreement or in all of these documents.<sup>206</sup> Pantzer and Deer<sup>207</sup> express two preferences which are worthy of attention. First, if one wants to bind third parties (exclusive of shareholders, officers, or directors), the charter is the proper instrument to use since the "bylaws are not filed or recorded and do not operate as notice to third parties."<sup>208</sup> Second, if it is desirable to deny shareholders certain customary rights or privileges (such as voting rights), the denial should be unequivocally stated in the articles. The reason is that "[i]nclusion of any controversial position in bylaws, even though adopted by shareholders, is not likely to be as efficacious. Most lawyers and judges expect important provisions to be in the charter."<sup>209</sup>

Since the close corporation is usually comprised of very few shareholders, most or all of whom take an active part in the management of the business, the maintenance of the established division of control within the business, especially against the invasion of outsiders, is of significant importance. In this respect, there are a number of specific control devices available to the close corporation.

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<sup>205</sup> *Id.*

<sup>206</sup> See notes 130, 131 *supra*, and accompanying text. See also UNIFORM COMMERCIAL CODE § 8-204.

<sup>207</sup> K. PANTZER & R. DEER, *THE DRAFTING OF CORPORATE CHARTERS AND BYLAWS* 29 (1968).

<sup>208</sup> *Id.* at 29-30.

<sup>209</sup> *Id.* at 30-31.

*Voting Trust.* The voting trust, whereby the shareholders transfer their stock to a trustee and confer upon him the right to vote or otherwise represent their shares, is one device which may be used for control purposes. To be valid in Texas, the voting trust must be in writing and must not exceed ten years duration.<sup>210</sup> In addition, a counterpart of the agreement must be deposited with the corporation at its registered office and the shares subject thereto must be transferred to the trustee or trustees for the purpose of the agreement.<sup>211</sup> Even if the voting trust meets the foregoing statutory requirements, it is equally important that the agreement be executed for a proper purpose. Thus, a voting trust established for the primary purpose of assuring the continued election of a certain person to a lucrative corporate office, and establishing his successor in that position, was held invalid as against public policy because it constituted an improper interference with the internal managerial affairs of the corporation.<sup>212</sup> On the other hand, a voting trust is not invalid simply because the person for whose benefit the trust was established is a settlor of the trust, is named as a voting trustee, and is the one who had the agreement drawn and who secured the signatures of most of the other parties thereto.<sup>213</sup>

*Voting Agreement.* Even though the voting agreement among shareholders was not favored under early Texas law,<sup>214</sup> use of the device as a means of control is now clearly permitted under the TBCA.<sup>215</sup> The voting agreement is a pact among shareholders that they will vote their shares as a unit, in the manner prescribed in the agreement, on corporate matters which are proper subjects for shareholder action. To be valid in Texas, such a voting agreement must be in writing and must not exceed ten years in duration.<sup>216</sup> In addition, a counterpart of the agreement must be deposited with the corporation at its registered office and the shares subject thereto must bear a legend stating that such shares are subject to the provisions of a voting agreement, a counterpart of which has been deposited with the corporation at its principal office.<sup>217</sup> In order to be specifically enforceable, such a voting agreement must meet the foregoing statutory requirements and must be executed for a proper purpose. Thus, such a shareholder agreement is permissible if entered into without fraud and if designed to accomplish only what the shareholders might have accomplished without the agreement.<sup>218</sup>

Conversations with other lawyers and the authors' experience indicate that voting agreements are favored over voting trusts. They are less for-

<sup>210</sup> TEX. BUS. CORP. ACT ANN. art. 2.30A (1956). See generally Comment, *Voting Trusts in Texas*, 12 Sw. L.J. 85 (1958).

<sup>211</sup> See authorities cited in note 210 *supra*.

<sup>212</sup> *Grogan v. Grogan*, 315 S.W.2d 34 (Tex. Civ. App. 1958), *error ref. per curiam*, 159 Tex. 392, 322 S.W.2d 514 (1959).

<sup>213</sup> 159 Tex. 392, 322 S.W.2d 514 (1959).

<sup>214</sup> See *Roberts v. Whitson*, 188 S.W.2d 875 (Tex. Civ. App. 1945), *error dismissed*.

<sup>215</sup> TEX. BUS. CORP. ACT ANN. art. 2.30B (Supp. 1968). Provision for the voting agreement was made in the Act by amendment in 1961.

<sup>216</sup> *Id.*

<sup>217</sup> *Id.*

<sup>218</sup> *Irwin v. Prestressed Structures, Inc.*, 420 S.W.2d 491, 492 (Tex. Civ. App. 1967), *error ref. n.r.e.*

mal, and hence easier to establish, and there is no disruption in ownership. But it must be admitted that voting trusts because of the transfer of ownership are more certain and less likely to be upset.

*Irrevocable Proxy.* Generally speaking, a proxy is the right held by one person to vote someone else's shares as the holder of the proxy may desire, and in this respect, the proxy is somewhat akin to the general power of attorney. When made irrevocable, the proxy becomes a useful device for exercising control within the close corporation. By statute, no proxy is valid more than eleven months from the date of its execution unless otherwise stated in the proxy, and the proxy is revocable unless expressly provided therein to be irrevocable or unless otherwise made irrevocable by law (*i.e.*, being coupled with an interest).<sup>219</sup> The phrase "coupled with an interest" has been defined by a Texas appeals court in *Roberts v. Whitson*,<sup>220</sup> in a negative vein when it declined to hold mutual promises contained in a voting agreement as sufficient to uphold a shareholders' agreement. The case is generally cited as representative of the restrictive view that the holder of the proxy must have a property or financial interest in the stock itself separate and distinct from the mere power to vote the shares; thus, a creditor would clearly have such a separate financial interest.<sup>221</sup> The more liberal view provides that any property interest in the proxy holder for which the stock is held for security is sufficient to render the proxy irrevocable even though the interest is not in the stock itself.<sup>222</sup> This latter interpretation is more consistent with economic realities for it recognizes the voting rights as an element of the property right, which it certainly is. But a corporate draftsman would be remiss if he relied on what the law should be. Indeed, the *Whitson* case is not alone in indicating the Texas courts' general reluctance to sanction restraints on alienation or freedom of use.<sup>223</sup> Thus, utilizing the irrevocable proxy (other than in a shareholder agreement) the cautious planner should insure that there is a separate financial interest apart from the stock. As this situation will seldom arise, the use of the irrevocable proxy in Texas is probably negligible.

As indicated earlier, TBCA (article 2.30B) specifically validates voting agreements, having been specifically enacted to overcome the *Whitson* case.<sup>224</sup> This section by granting enforcement in equity of voting agreements seemingly validates irrevocable proxies contained therein even if they only are supported by mutual promises, *i.e.*, no separate, independent consideration.

#### *Other Control Devices.* Requiring very high or unanimous shareholder or

<sup>219</sup> TEX. BUS. CORP. ACT ANN. art. 2.29C, *as amended*, (Supp. 1968). See generally Comment, *Irrevocable Proxies*, 43 TEXAS L. REV. 733 (1965).

<sup>220</sup> 188 S.W.2d 875 (Tex. Civ. App. 1945), *error ref. w.o.m.*

<sup>221</sup> See, *e.g.*, C. CAVITCH, BUSINESS ORGANIZATIONS § 144.04(3), at 229 (1969). Other cases representative of this restrictive view are *In re Chilson*, 19 Del. Ch. 398, 168 A. 82 (Ch. 1933); *Areweld Mfg. Co. v. Burney*, 12 Wash. 2d 212, 121 P.2d 350 (1942).

<sup>222</sup> See, *e.g.*, *Deibler v. Chas. H. Elliott Co.*, 368 Pa. 267, 81 A.2d 557 (1951).

<sup>223</sup> See, *e.g.*, *Sandor Petroleum Corp. v. Williams*, 321 S.W.2d 614 (Tex. Civ. App. 1959), *error ref. n.r.e.*; *Grogan v. Grogan*, 315 S.W.2d 34 (Tex. Civ. App. 1958).

<sup>224</sup> See Comment of Bar Committee, 3A TEX. REV. CIV. STAT. ANN. 121 (1956).

director approval in order to take action offers another control device. However, the possibility of deadlock or stagnation of corporate action is one disadvantage weighing against the establishment of high or unanimous shareholder or director voting requirements. If such requirements are established, provision for arbitration should also be made in the appropriate corporate document (*e.g.*, shareholder agreement, bylaws, etc.) in order to avoid a deadlock. If an unbreakable deadlock should result, article 7.05 of the TBCA provides for the appointment of a receiver to rehabilitate the corporation (a) when the directors are deadlocked in the management of corporate affairs and the shareholders are unable to break the deadlock and irreparable injury to the corporation is being suffered or is threatened, and (b) when the shareholders are deadlocked in voting power and have failed for a period, including two annual meeting dates, to elect successors to directors whose terms have expired or would have expired upon the election and qualification of their successors.<sup>225</sup>

Placing restrictions on the transferability of shares also provides a means for exercising control within the close corporation, especially in view of the fact that such restrictions are usually designed to restrict the transfer of shares to "outsiders," persons who have not previously participated in the affairs of the corporation.<sup>226</sup>

## V. CONCLUSION

No article could properly convey all of the possible variations and considerations involved in incorporation planning. For this reason, and because corporation statutes are essentially enabling legislation,<sup>227</sup> the lawyer should not simply rely on stock forms but rather should tailor each corporation to the individual needs of his client. This is not to say that forms are not useful, but merely that they are tools which the legal craftsman must use with care and with recognition that each incorporation is a special, unique product. The forms themselves are available in quantity, and the authors have made no attempt to increase the supply here. What we have sought to do is provide background information (including substantive detail) which should assist the lawyer in selecting and preparing meaningful corporate documents designed to carry out the wishes of his client efficiently and accurately.<sup>228</sup>

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<sup>225</sup> See TEX. BUS. CORP. ACT ANN. art. 7.05A(1)(b), (c), *as amended*, (Supp. 1968).

<sup>226</sup> For a more detailed discussion of the restrictions on the transferability of shares, see text accompanying notes 129-40 *supra*.

<sup>227</sup> Latty, *Why Are Business Corporation Laws Largely "Enabling"?*, 50 CORNELL L.Q. 599 (1965).

<sup>228</sup> The authors highly recommend the forms contained in A. BROMBERG, *SUPPLEMENTARY MATERIALS ON TEXAS CORPORATIONS* (1965).